Credit Outlook

24 February 2020

NEWS AND ANALYSIS

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US ports will manage coronavirus disruption barring widespread outbreak

Originally published on 18 February 2020

The coronavirus outbreak is disrupting supply chains within China, which is curtailing exports to US ports. Within China, the outbreak has caused extended factory closures, restricted goods movements, and led ocean carriers to cancel more than 80 sailings from Chinese ports scheduled for February and March.

If the outbreak remains largely contained and the disruption proves short-lived, as we expect will be the case, the credit effect will be only modestly negative for the outbreak's duration and immediate aftermath and ultimately manageable for US ports. We expect a healthy recovery in shipments in subsequent quarters once supply chain conditions return to normal.

- **Factory shutdowns for coronavirus will lower US port volumes into second-quarter 2020.** Coronavirus is disrupting supply chains within China, with factory closures, travel restrictions and canceled sailings curtailing exports to US ports. Chinese port export volumes in first-quarter 2020 could decline 10%, according to Alphaliner, a provider of maritime data. Because of the time it takes to sail to the US from Asia, the effect on US ports' throughput will not emerge until February and March.
- **US West Coast ports are most exposed but the impact will be mitigated by contractual revenue guarantees.** The risk is most pronounced for US West Coast ports such as Los Angeles (Aa2 stable) and Long Beach (Aa2 stable), where China accounts for half of two-way trade. However, the risk of lower near-term volumes will be mitigated by the contract structures under which these ports operate. West Coast ports operate as “landlords” and typically receive high levels of minimum annual revenue guarantees (MAGs) from tenants. These ports also have strong credit profiles, with healthy debt service coverage ratios, strong liquidity and near-record cargo volumes that support their ability to tolerate modest near-term volume declines.
- **US cruise market has limited direct exposure to China, but financial effects on cruise lines and hesitation by travelers could prove challenges.** For now, US cruise travel has not experienced any meaningful disruption because sailings are comparatively short-haul in nature and focused in the Caribbean and Mexico, which have not yet experienced any material contamination or necessary quarantines of vessels. But a series of high-profile incidents could ultimately lead to softer bookings or cancellations by passengers, and lower revenues for cruise lines.

Click here for the full report.

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Coronavirus will delay demand and possibly disrupt supply chain for US chip makers

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The spread of the coronavirus in China is credit negative for US semiconductor companies that generate a large portion of revenues from sales to Chinese manufacturers or depend on end market demand from Chinese consumers. US companies whose supply chains include critical components manufactured in China are also exposed. Several US logic and analog semiconductor companies with exposure to China have already lowered their next quarter earnings outlook because of the crisis.

Much of the Chinese population remains under some form of quarantine or travel restriction, which is limiting staffing levels at factories and depressing retail sales. Because of these restrictions, the coronavirus crisis can hamper semiconductor industry revenue through four primary pathways: reduced end market demand; reduced demand from Chinese manufacturers of exported products; reduced semiconductor chip production in China; and supply chain disruption.

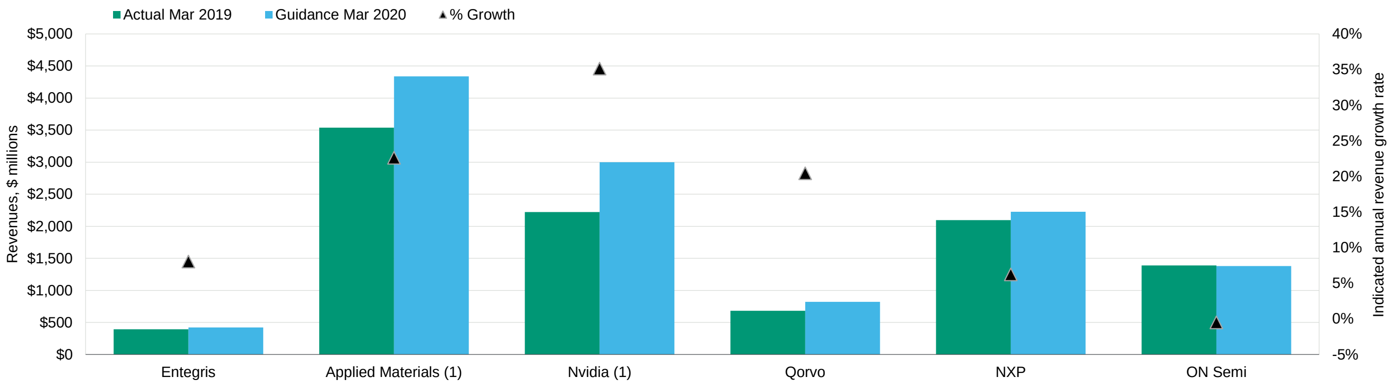
The quarantine covers an aggregate population of over 20 million, including the city of Wuhan, where the outbreak began. Our baseline assumption is that the disruption will be temporary and the impact limited to the first quarter of the year. Under this scenario, we believe any delay in demand would quickly reverse itself once the quarantine is lifted resulting in little to no permanent revenue loss.

Under a downside scenario of a more prolonged coronavirus outbreak, exposed semiconductor firms would have a slower revenue recovery from the 2019 semiconductor industry downturn. Capacity utilization by chip manufacturers may decline as well, leading to reduced gross margins. In the unlikely scenario where chip manufacturers maintain their production levels, inventories would likely accumulate at the manufacturers, and possibly in the distribution channel. This accumulation of excess inventory would depress demand, likely triggering a downturn in the semiconductor market.

In response to the crisis, some rated semiconductor companies have reduced their earnings outlook for the next quarter by about 5%. II-VI Inc (B1 stable), which makes engineered materials and optoelectronic devices, has lowered their quarterly revenue guidance by about 8% to reflect the disruption caused by the travel restrictions. But others, such as Entegris Inc. (Ba1 stable), which supplies semiconductor fabrication facilities, have widened their guidance by lowering the low end of their revenue outlooks in order to account for uncertainty related to the outbreak. Qorvo Inc (Ba1 stable), which produces radio frequency (RF) filters and modules used in smartphones, is anticipating a delayed impact, with the coronavirus affecting revenue in the June quarter.

Still, given that most semiconductor firms are recovering from the 2019 industry downturn, the impact of the coronavirus crisis generally is reflected in reductions in expected growth rates rather than outright revenue declines (see exhibit). Applied Materials Inc. (A3 stable), the world's largest semiconductor equipment manufacturer, has lowered its quarterly revenue guidance by about 8%, with the company now anticipating an annual growth rate of 23% versus the 31% it anticipated prior to the coronavirus crisis. Likewise, Qorvo's June revenue impact would result in approximately flat revenue year over year.

Expected revenue growth across a select range of semiconductor firms



(1) For Applied Materials and Nvidia, quarters end in April.
Sources: Company SEC filings and press releases

Reduced retail spending will lower end-market demand

We believe that the quarantines, along with related travel restrictions, will reduce retail spending in China. This will lower end market demand for products that incorporate semiconductor chips, such as cars, smartphones and other consumer electronics, at least temporarily. Although a large share of consumer electronics are purchased online, retail stores remain an important sales channel for many products, such as smartphones, so the quarantine will drive a dip in their sales. Still, we believe the sales dip will only delay demand, which will likely reverse following the lifting of the quarantine, provided it does not go beyond the first quarter.

Demand from Chinese manufacturers of exported products will also decrease

With travel restrictions in place in Wuhan and surrounding cities limiting worker mobility, many factories will face staffing shortages and shutdowns, which can disrupt production of exported products that incorporate semiconductors. These include various types of consumer electronics and industrial equipment. Given the extended Chinese New Year holiday through 9 February, it is difficult to determine the risk of extended factory shutdowns. Indeed, the contract manufacturing sector has continued production.

Semiconductor chip production in China may also slow

With the travel restrictions in place, semiconductor fabrication facilities located in China may be forced to shut down or operate on a reduced schedule, which would limit production of semiconductor chips. But Entegris, a supplier to semiconductor production facilities, recently noted that most of its semiconductor customers are up and running. Based on this as well as various news reports, we do not believe chip fabrication has been impacted so far.

An extended outbreak could disrupt supply chains

With travel restrictions in place causing staffing shortages, the production of parts in China for export to final assembly facilities globally could be disrupted. This reduced supply of parts would reduce production of final goods, which would ultimately hamper demand for all supplies needed to complete those goods, including semiconductor chips.

Such disruptions have already occurred. For instance, Hyundai Motor Company (Baa1 negative) recently reported difficulty obtaining wiring harnesses from its suppliers that rely on factories in China. As a result, it temporarily shut down some of its Korea-based plants. Should the crisis last beyond the first quarter and customer safety stock inventories are depleted, this risk could materialize more broadly. While this is an evolving situation, we do not anticipate significant broad-based supply chain issues for materials sourced from China at this time.

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Coronavirus outbreak will lower Meinian Onehealth's medical center utilization, a credit negative

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The restricted flow of people around China because of measures to counteract the spread of the coronavirus outbreak is credit negative for Meinian Onehealth Healthcare Hldg. Co., Ltd. (Ba3 negative) because underutilization of its medical centers will reduce the company's revenue in the near term.

The Government of China (A1 stable) has implemented a series of quarantine measures, including extending the Lunar New Year holiday period, delaying the return of employees back to work and encouraging people to remain indoors whenever possible, to minimize the spread of the coronavirus.

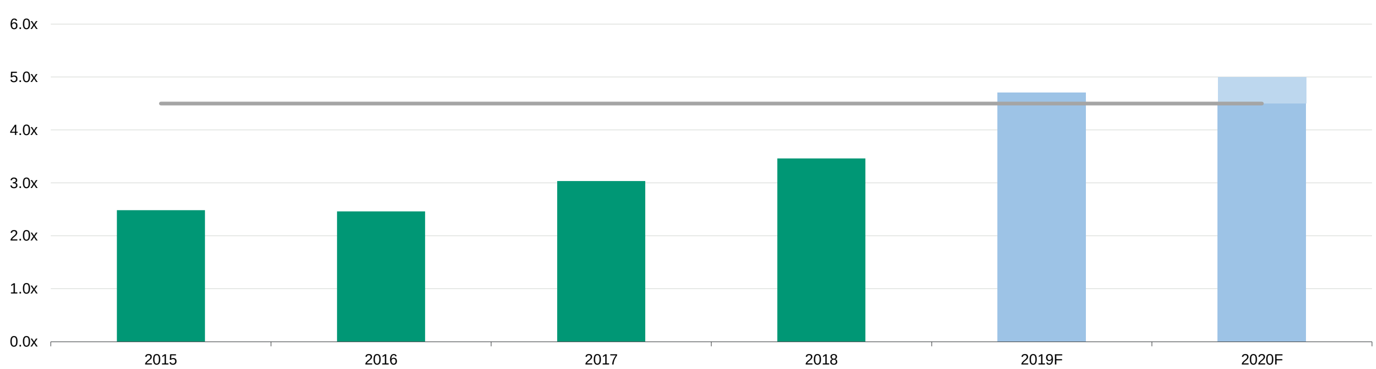
These measures have affected Meinian Onehealth's ability to open and operate many of its medical centers, particularly those in the Hubei province and its capital Wuhan, the region with the highest number of people who have contracted the virus. We estimate the company's medical centers in the Hubei province contribute around 5%-6% of its total annual revenue.

We estimate that closure and underutilization of the company's medical centers nationwide will lead to a reduction in its total revenue of 10%-15% for 2020 from our previous revenue forecast of around RMB10.8 billion for the year. Our estimate also takes into account that the first quarter of the year is traditionally a slower period for medical checkup operators in China.

Our revenue-loss estimates are based on the assumption that the company's medical centers in Hubei province are unable to operate for the first quarter 2020, while its medical centers outside the province are unable to operate for six to eight weeks in the first quarter. However, we expect Meinian Onehealth's EBITDA margin will be relatively steady at 19%-20% because the company will benefit from rental relief on its medical center properties over the corresponding period.

Accordingly, Meinian Onehealth's leverage – measured by adjusted debt/EBITDA – will remain high for the rest of 2020 at 4.5x-5.0x under our scenario (see exhibit).

Meinian Onehealth's leverage is likely to stay high for 2020



Sources: Moody's Financial Metrics and Moody's Investors Service estimates

However, Meinian Onehealth's medical centers are geographically diverse in China and the potential increase in demand from companies completing medical checkups for their staff before they return to work could provide support for the company's revenue.

We expect that Meinian Onehealth's medical centers will recover gradually after the outbreak-driven disruptions are contained, although we are uncertain about the length and intensity of those disruptions.

Under the above scenario, we expect the company to have sufficient liquidity. The RMB2.046 billion raised from an equity placement in November 2019, which has increased Alibaba (China) Technology Co and its affiliates' ownership stake to 14.39% in Meinian Onehealth, has improved its liquidity position. This combined with the company's cash balance of around RMB2.0 billion as at 30 September 2019 and an expected operating cash flow generation of RMB1.2 billion to RMB1.3 billion, are sufficient to cover its short-term debt of about RMB2.6 billion and likely capital spending of RMB1.8 billion-RMB2.0 billion in the next 12 months.

Meinian Onehealth has also been helping the central government to combat the coronavirus outbreak. The company has been sending its medical staff and medical testing equipment to affected areas. These efforts are credit positive for Meinian Onehealth in the long term because we expect they will enhance the company's social reputation and standing in the community. However, the use of employees for this purpose could add some constraints to the company's operations in the short term because of shortages of skilled staff.

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China's new toll-free policy amid coronavirus outbreak is credit negative for toll road operators

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On 17 February, China's Ministry of Transport new toll-free policy for all toll roads and bridges took effect as part of efforts to support the resumption of operations across various sectors following the coronavirus outbreak. The new toll-free policy is credit negative for Chinese toll road operators because we expect their financial profiles will be weakened by the reduction in revenue, and the strain on cash flow will also tighten their liquidity and increase refinancing risk in the short term.

The extent of the financial effect on the toll road sector will depend on the duration of the toll-free period and any potential compensation from the government,[1] as well as any countermeasures that the issuers may implement to offset the decline in revenues. The regulator did not specify a time frame but indicated the policy will end upon the completion of coronavirus prevention and containment work.

We expect the forms of compensation could include, among other things, direct government subsidies, extensions to the concession life of toll road projects, as well as extensions of credit facilities by domestic banks. The cash flow impact of any compensation measures will depend on the form of measures taken, for example, extensions to the concession life of toll roads providing the least immediate relief to any potential short-term cash flow issues of the operators.

Notwithstanding that the new policy will compress the rated toll road operators' financial capacity, we expect the liquidity and refinancing risk of most rated toll road operators to remain manageable in the near term because of their adequate cash on hand compared to maturing debt in the next three to six months and proven funding access to meet any funding gaps.

However, at this stage, it is difficult to gauge the full effect of the disruption from the coronavirus outbreak and the new toll-free policy because it will depend on, among other things, the duration of the toll-free policy period and the form and timing of government compensation. Assuming that the disruptions from coronavirus outbreak are short term, we expect the policy measure for toll roads will be temporary, although traffic ramp up will take time, depending on asset location. Under our macroeconomic baseline forecast, we assume the spread of the coronavirus will be contained by the end of first quarter, allowing for resumption of normal economic activity in the second quarter.

We will continue to closely monitor developments and engage with issuers (see exhibit) to ascertain the credit-negative implications of the new policy measure.

Rated Chinese transportation issuers

Issuer	Rating	Outlook	Sector	Key service regions
Anhui Transportation Holding Group Co., Ltd.	Baa1	Stable	Road	Anhui Province
Guangxi Communications Investment Gr Corp Ltd	Baa2	Stable	Road & Rail	Guangxi Province
Guangzhou Communications Investment Group	Baa2	Stable	Road & Rail	Guangzhou City
Qilu Transportation Dev. Grp. Co., Ltd.	A3	Stable	Road	Shandong Province
Shandong Hi-speed Group Co., Ltd	A3	Stable	Road & Rail	Shandong Province
Shenzhen Expressway Company Limited	Baa2	Stable	Road	Shenzhen City
Shenzhen International Holdings Limited	Baa2	Stable	Road	Shenzhen City
Yuexiu Transport Infrastructure Limited	Baa2	Negative	Road	Guangzhou City & Hubei Province

Source: Moody's Investors Service

Endnotes

1 The Ministry of Transport released a commentary on the new toll-free policy indicating that compensation will be provided "to protect the interest of investors, operators and creditors in the toll road industry." However, there were no specific details regarding the form and timing of the compensation.

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Cyberattack on undisclosed pipeline is credit negative for pipelines and utilities

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On 18 February, the US Cybersecurity and Infrastructure Security Agency (CISA) alerted asset owners and operators of all critical infrastructure sectors that it had responded to a recent cyberattack on an undisclosed natural gas compression facility. Cyberattacks on pipeline and other key infrastructure assets are credit negative because of the material operational disruption and significant financial loss that can result if these assets are damaged in a successful attack.

The attack began with a spear-phishing email that enabled access to the targeted organization's information technology (IT) network and subsequently to the control and communication assets on its operational technology (OT) network. The attacker blocked access to both networks in exchange for a ransom payment. Although the cyberattack was limited to one compression facility, pipeline transmission dependencies made a controlled shutdown of the entire pipeline asset prudent. The shutdown resulted in two days of lost productivity and revenue.

The targeted organization had no specific emergency response plan for cyberattacks, underscoring the vulnerability of the natural gas pipeline sector to cyberattacks.[1]

Although the US utilities sector has long been subject to mandatory cybersecurity standards, the US natural gas pipeline industry, now the primary fuel supplier to the US power generation fleet, has no federally mandated cybersecurity standards and we think the sector is poorly equipped to handle cybersecurity attacks. Notwithstanding the utility sector's more stringent cybersecurity standards, utilities are vulnerable to pipeline cyberattacks. Natural gas distribution utilities rely on pipeline infrastructure for gas distribution to customers for heating and other purposes, exposing them to the safety, operational and financial risks from pipeline cyberattacks. Because of the increased interdependence between electric utilities and natural gas pipelines amid the growing use of low-cost natural gas as a transition fuel to renewables and away from coal, the electric grid infrastructure is exposed to cyberattacks on natural gas pipelines.

As with this incident, where the attacker pivoted from the IT network to the OT network, the increasing reliance of pipeline operators on networked computer systems and electronic data leaves them exposed to attacks from cybercriminals. Federal enforcement of stricter standards, such as more stringent requirements for separation between IT and OT networks, would help address the vulnerability of pipelines to cyberattacks. However, the responsibility for protecting these assets from a cyberattack ultimately is with asset owner and/or operator management and board of directors.

Endnotes

1 See **Pipeline cybersecurity standards help plug security loophole in utility supply chain**, 10 July 2019.

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MGM Resorts confirms data security incident

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On 20 February, MGM Resorts International (MGM, Ba3 positive) disclosed that it was a victim of a 2019 data breach that involved unauthorized access to a cloud server that contained guest information. Although the episode does not currently affect MGM's ratings or outlook, it is credit negative for the company. The incident highlights key risks to entertainment and hospitality companies that handle large amounts of personal data on customers.

Additional risks to MGM include reputational risk and the potential for direct costs associated with investigation and remediation, as well as any litigation expense or liability that the company may have with respect to compromised data. However the company's cyber insurance policy may at least partially mitigate any direct financial impact associated with the breach.

The personal information of more than 10 million users, including names, addresses, phone numbers, and email addresses were accessed. About 1,300 individuals had more sensitive data exposed, including driver's license, passport or military ID card information. According to the company, the incident did not involve the disclosure any financial, payment card or password data. The company also said that affected guests were notified of the breach.

The MGM episode is smaller than some other notable breaches in terms of the number of affected customers. For example, a 2017 breach at Marriott International, Inc. (Baa2 stable) affected roughly 500 million guests. Nevertheless, MGM will face longer-term risks, including potential reputational damage and the potential concerns of guests about staying at its properties. The company's management has said that it has retained two cybersecurity firms to investigate the incident and that the company has enhanced its network security in an effort to prevent future breaches.

In a cyber risk assessment framework we published in February 2019, we identified the hospitality industry as carrying medium-high cybersecurity risk, in large part because of the large amount of valuable personal data these companies maintain.[1] This data in some cases may include personal information about US executives and government officials with security clearances that are particularly prized by nation state hacker communities. We defined sectors at medium-high risk as having multiple vulnerabilities to cyberattacks, including a heavy reliance on technology to operate.

MGM owns and operates casino resorts in Las Vegas, Nevada; Springfield, Massachusetts; and, through its majority ownership stake of MGM China Holdings Limited, the MGM Macau resort and casino and MGM Cotai, which opened in February 2018. MGM also owns 50% of CityCenter in Las Vegas and a majority stake in MGM Growth Properties (MGP), a real estate investment trust formed in April 2016. MGM has entered into a long-term triple net master lease with MGP pursuant to which the company leases and operates 14 properties for MGP. Consolidated net revenue for 2019 was approximately $12.9 billion.

Endnotes

1 Our framework rank ordered the cyber risk of 35 broadly defined sectors from high to low.

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Ransomware attack against logistics company Toll Group points to rising cyber event costs

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A recent ransomware attack against Toll Group, an Australia-based logistics company with operations in 50 countries and 1,200 locations, points to global companies' rising cyber risks. The episode also highlights how a failure to communicate transparently and manage expectations during a cyber event can often have negative consequences for a company.

Toll Group, which had $5.8 billion in revenue in the fiscal year that ended in March 2019, continues to struggle to return to full operations more than two weeks after announcing it had fallen victim to a ransomware attack. The total cost of the attack has yet to be tallied, but recent history suggests it is likely to be substantial. We do not rate the company, but we assessed the broader transportation services industry, which Toll is a part of, at medium-high cybersecurity risk in our February 2019 framework for understanding relative levels of cyber risk across sectors.[1] We defined sectors at medium-high risk as having multiple vulnerabilities to cyberattacks, including a heavy reliance on technology to operate; however, they also have some ability to reduce an attack's operational impact through established manual processes.

The Toll Group attack illustrates how cyber risks across many sectors are rising globally. The attack has significantly disrupted Toll Group's operations, reportedly compromising 1,000 systems[2] that have affected local and global deliveries. The company has taken down up to 500 applications that supported its operations across 25 countries, and it has partially reverted to more time-consuming and expensive manual processes. Delivery delays may also trigger payment penalties to its customers for failing to meet contractually agreed to delivery timelines.

Some of Toll Group's large corporate customers, including Unilever Plc (A1 stable), Adidas A.G., and Nike Inc. (A1 stable), have announced that they plan to use competitors' services as a result of the disruption. Although it is too early to say if this shift will be permanent, customers' negative experiences in the aftermath of the cyberattack could translate into a loss of customers for the company. Toll will also have significant remediation expenses to upgrade and/or replace affected information technology (IT) systems, which will add to the total costs of the attack.

Toll Group has said that it is working closely with its customers at the site level to return to full operational capability. However, the company has faced criticism from some customers for its communications policies. Some individuals have taken to social media to complain that the company's service line provided minimal information and made promises about impending deliveries that failed to materialize.

While a company can incur negative consequences if it fails to communicate transparently and manage expectations during a cyber event, the reverse is also true. For example, in 2019 a ransomware attack disrupted the services of Norsk Hydro A.S.A (Baa2 negative), an aluminum and energy company with global operations. The company's senior staff hosted daily webcasts in which they answered audience questions. A year later, Norsk Hydro has seen no notable customer defections resulting from the event and it is regularly cited as a best-in-class example of how to communicate with the broader public about ransomware events.

Although not as expansive from a global impact standpoint, the Toll Group attack is reminiscent of the 2017 NotPetya attack that caused significant disruptions to the global supply chain and affected the operations of shipping giant A.P. Moller-Maersk A.S. (Maersk, Baa3 stable) and FedEx Corporation's (Baa2 negative) TNT Express subsidiary (see exhibit). NotPetya blocked Maersk's access to its electronic booking systems and ultimately forced a 10-day overhaul of its entire IT infrastructure. Maersk replaced 4,000 servers, 45,000 computers and 2,500 applications before returning to full operations within 10 days of the event. Altogether, Maersk realized $300 million in unplanned expenses. For FedEx, costs of the attack totaled $400 million from revenue losses resulting from decreased shipments within the TNT Express network, as well as incremental costs to restore IT systems. FedEx, however, partially mitigated the disruption to its customers by offering to move cargo requests onto TNT Express' sister company FedEx Express, which helped it retain customers within the broader franchise.

Operational disruption costs of ransomware attacks on companies are significant

Company	Toll Group	Maersk	FedEx Corp.	NorskHydro
Rating	Not rated	Baa3	Baa2	Baa2
Date of cyber event	Jan-20	Jun-17	Jun-17	Mar-19
Revenues ($MM)	5,810	30,945	65,450	16,052
EBIT ($MM)	85	517	4,272	245
Cost of event ($MM)	TBD	300	400	60-70

Except for Toll Group, financial information shown represents the full-year results for the year in which the cyber event occurred. Toll Group financial information is for the fiscal year ended 31 March 2019.
Sources: Company filings

Endnotes

1 Our framework rank ordered the cyber risk of 35 broadly defined sectors from high to low.

2 See Toll Group tight-lipped on alleged ransomware attack, 4 February 2020.

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L Brands' separation of Victoria's Secret will enable focus on core Bath & Body Works, a credit positive

Originally published on 20 February 2020

On 20 February, L Brands, Inc. (Ba2 review for downgrade) announced that it will be separating Victoria's Secret by selling a majority stake to Sycamore Partners, a private-equity firm specializing in consumer and retail investments. The separation will enable L Brands to focus on its core Bath & Body Works business, which comprises more than 85% of its operating income, and reduce funded debt by approximately $1 billion, both credit positive. The repayment of debt will enable the company to address its near-term maturities given that approximately $1.3 billion is due over the next two years.

Sycamore will be paying approximately $525 million for a 55% controlling equity interest in the new entity while L Brands will retain 45%. The implied enterprise valuation is approximately $1.1 billion, or a multiple of 2.3x EBITDA last-12-month period that ended 2 November 2019, which appears to be less than that of most publicly traded apparel retailers. The transaction has been approved by the L Brands board of directors and the parties expect it to close in the second quarter.

L Brands's rating remains on review for downgrade. We expect the transaction to increase leverage modestly to approximately a debt/EBITDA ratio of 3.7x from 3.4x for the last-12-month period that ended 2 November 2019. Our calculation is based on the reduction of the entire $2.5 billion lease obligation for Victoria's Secret, the repayment of $1 billion of funded debt, and the allocation of corporate expenses based on a percentage of sales.

Leverage could be higher to the extent that there are Victoria's Secret leases that are guaranteed by L Brands, or dissynergies that are not offset by any potential transition agreement arrangements and higher than anticipated corporate expenses. The amount of Victoria's Secret leases guaranteed by L brands have not been disclosed. Dissynergies associated with the transaction, such as corporate, information technology and supply chain were also not disclosed.

The transaction will remove the risks associated with the turnaround of the Victoria's Secret business, particularly given the challenges associated with repositioning the brand amid significant changes in the demands of its target customer and an intensely competitive environment. Nonetheless, executing the separation and dismantling the integration of supply chain functions, purchasing, information technology and corporate remain challenges in the near term. We also recognize that L Brands will be smaller in scale and diversification and reliant on one concept, notwithstanding Bath & Body Works' growth and consistency.

Senior leadership is also being streamlined with Leslie Wexner stepping down from as chairman and CEO. Andrew Meslow, the current COO of Bath & Body Works, will become CEO of L Brands and will join the board. Bath & Body Works CEO Nick Coe was named vice chairman of Bath & Body Works Brand Strategy and New Ventures to focus on the strategic positioning of the business.

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Dairy Farmers of America's acquisition of Dean Food’s assets would be credit positive

Originally published on 19 February 2020

On 17 February, Dairy Farmers of America, Inc. (DFA, Baa2 negative) announced that it had agreed to become the stalking-horse bidder to acquire 44 of Dean Food Company's facilities as well as the associated direct store delivery system. The agreed-upon base purchase price is $425 million. The deal is subject to review and approval by the Bankruptcy Court overseeing Dean's Chapter 11 reorganization and The US Department of Justice.

The acquisition would be credit positive for DFA because it will provide clarity on both Dean's business and the outlet for DFA members' milk moving forward. However, we expect the acquisition will be initially fully debt financed. Assuming the proposed transaction proceeds on its current terms, we anticipate that the company's pro-forma debt/EBITDA will rise by approximately 0.5x to 3.7x. We further expect that DFA will continue to delever following the acquisition to levels within the credit profile, thus we could reevaluate the outlook should the transaction proceed as proposed.

DFA’s purchase of Dean’s assets will increase business risk because the company will be acquiring operations with significant exposure to declining fluid milk consumption that has been challenged for several years. Dean had a series of operational missteps such as poor management of regional brands and poor execution of plant closings that contributed to a material loss in customer contracts and declining earnings and significant cash consumption. DFA’s ability to turn around Dean’s business will depend on successfully gaining back customers, improving customer relationships and restoring profitability at underperforming plants.

DFA's credit profile is supported by its position as the largest farmer-owned dairy marketing cooperative in the US. DFA and its members benefit from the cooperative's significant network of owned and affiliated processors and food and beverage manufacturers that provide stable outlets for members' milk. The company's cooperative structure provides financial flexibility that, in a stress scenario and on an infrequent basis, would allow it to quickly improve cash flow through adjustments in milk payments to dairy farmers.

The company must maintain a relatively conservative financial profile in order to successfully manage the earnings volatility resulting from milk input costs that is inherent in its value-added and affiliate businesses. DFA's credit profile is also constrained by the low-margin, commodity nature of its core fluid milk business.

DFA, headquartered in Kansas City, Kansas, is the leading US milk marketing cooperative. It is owned by and serves nearly 14,000 dairy farmer members representing more than 8,000 dairy farms in 48 states. DFA reported revenue of $15.1 billion for the 12 months that ended 30 September 2019. The cooperative markets about 30% of the total milk volume in the US.

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SEC investigation of Fluor is credit negative

Originally published on 18 February 2020

On 18 February, Fluor Corporation (Baa3 stable) announced that the US Securities and Exchange Commission (SEC) is investigating the company's past accounting and financial reporting. The investigation is credit negative since it indicates possible weaknesses in internal controls and corporate governance, and could result in restatement of prior period financial results and monetary penalties against the company.

The SEC is investigating Fluor's accounting and financial reporting and requested documents and information related to projects for which the company recorded charges of about $700 million in the second quarter of 2019. In light of the SEC data requests, the company has decided to conduct an internal review of its prior period reporting and related control environment. It has not made a determination as to whether there are prior period material errors, but does not expect to file its annual report on Form 10-K prior to the end of February given the ongoing internal review.

Fluor also announced its intention to retain its Government business since it has become more comfortable with its liquidity position and its options for generating cash flow, developments that will strengthen its credit profile. Therefore, it no longer deemed it necessary to proceed with the sale of this business. Keeping this business positively affects the company's risk profile since it enables it to maintain sizeable scale and end-market diversity and retain a less cyclical and consistent cash-generating business.

The company's stronger-than-expected liquidity position including $2 billion of cash and marketable securities as of December 2019, and its confidence in generating additional cash from asset sales and receivable collections is also a positive development. Fluor continues to market its AMECO equipment business for sale and anticipates significant progress with one or more potential buyers by the end of the second quarter. It has also received solid indications of interest for its P3 investments, surplus real estate and other assets.

Fluor provided preliminary select financial results for the fourth quarter that included non-cash impairment charges, the write-off of deferred tax assets and non-cash expenses related to its UK pension plan settlement. However, it did not disclose any charges related to project cost overruns in the quarter, but did not rule out the possibility of charges since it cannot close the books on the fourth quarter until it files its Form 10-K.

The company's financial projections for 2020 assume a return to materially positive earnings after losses in 2019. These projections assume the company benefits from its strategic turnaround initiatives and produces a slight increase in revenue even though its backlog has declined by about 18% to $32.7 billion versus $39.9 billion last year. Even if the company meets its financial projections, its credit metrics will likely remain weak for its Baa3 senior unsecured rating in the near term. Fluor's ratings could face downside pressure if it continues to have bidding and execution issues and its operating results do not strengthen materially.

Headquartered in Irving, Texas, Fluor provides engineering, procurement, construction and maintenance services globally and is a large contractor to the US government. Fluor reports its revenue in four market segments: Energy & Chemicals (43% of current backlog), Mining & Industrial (16%), Infrastructure & Power (21%), Government (12%), and Diversified Services (8%). Fluor's revenue for the 12 months that ended 30 September 2019 were $17.8 billion and its backlog was $32.7 billion.

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Dell's divestiture of its RSA unit is credit positive

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On 18 February, Dell Technologies, Inc., the parent of Dell Inc. (Ba1 stable), announced that a consortium of investors led by Symphony Technology Group plans to acquire RSA for $2.075 billion in an all-cash transaction. Dell expects the transaction to close in the next six to nine months. The divestiture of RSA is credit positive because it will augment Dell's capacity to reduce debt quickly and we expect the majority of the net proceeds from the sale to be applied toward debt repayment.

We believe that RSA's portfolio of legacy security products are noncore to Dell's strategic goals. RSA became a part of Dell through the acquisition of EMC in 2016. EMC had acquired RSA in 2006 for approximately $2.1 billion. RSA offers a portfolio of security solutions such as identity and access management, threat detection and response, risk management, and fraud prevention.

The planned divestiture is in line with Dell's focus on simplifying and rationalizing its portfolio of product offerings since the EMC merger. While Dell is divesting RSA's security product portfolio, the company remains committed to strengthening its security offerings targeting the infrastructure and end-point security segments through its VMware subsidiary. In October 2019, VMware completed the acquisition of cloud-based endpoint security provider Carbon Black for approximately $2.1 billion. VMware also offers Workspace One, a platform offering for managing end-point devices. Dell additionally owns a majority interest in SecureWorks Corp, a provider of managed security and threat detection solutions.

We expect that proceeds from the RSA divestiture, net of taxes, will augment Dell's capacity to pare debt and reduce leverage in line with its goal to reduce leverage to 3x or below on the company's adjusted debt to EBITDA basis. The company is on track to repay about $5 billion of "core" debt in the fiscal year that ended January 2020, and another $4 billion in fiscal 2021. Dell has not specified the expected proceeds, net of taxes, from the sale of RSA, or the intended use of proceeds.

Although the credit agreement allows for the flexibility to reinvest the proceeds, we expect that the primary use of net proceeds will be to reduce debt. Our view is supported by the company's track record of reducing debt from proceeds generated from divestitures of software and services assets since the EMC acquisition and its goals of reducing leverage and achieving investment grade ratings.

Dell's Ba1 rating and stable outlook are not affected at this time because we believe that Dell's leverage will remain high over the next 12 months. On a Moody's-adjusted basis and adjusting to reflect 81% of VMware's ownership, Dell's total debt/EBITDA was approximately 4.7x as of the fiscal 2020 third quarter (including $1 billion of transition tax liabilities). Assuming $4 billion of debt repayment in fiscal 2021, we estimate that Dell's leverage will decline to about 4x by year-end fiscal 2021. This view incorporates our expectation for low-single-digit growth in consolidated revenue but a decline in EBITDA in the low single digits. Revenue growth will be primarily driven by VMware's organic growth and recent acquisitions. We believe that EBITDA margins at Dell will face challenges over the next 12 to 18 months as a result of declining PC sales after the Windows operating systems refresh cycle, higher component costs, and increasing global macro uncertainty.

We also believe that there is an upside to our estimates of profitability. Dell has demonstrated the ability to execute well on its ability to gain or hold market share in the PC and storage segments, focus on profitable growth in the servers segment, and achieve operating efficiencies. New storage products introduced by Dell create the opportunity for growth in the higher-margin storage segment. Investments in sales capacity that pressured margins over the last year will likely taper down and cushion the effect from rising component costs and a potential decline in PC sales during fiscal 2021.

We believe that Dell has low direct exposure to the fallout of the coronavirus epidemic due to its diversified supply chain. But its business is highly correlated with global IT spending volumes and in particular, continued growth in IT spending on on-premise and private cloud infrastructures.

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Blockades are credit negative for Canadian National Rail and TC Energy

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On 18 February, Canadian National Railway Company (CN, A2 stable) announced it would temporarily lay off about 450 workers, following its 13 February decision to suspend its Eastern Canadian network operations because some of Canada's indigenous groups and their supporters have blockaded rail lines and other transportation routes to protest the construction of the Coastal GasLink (CGL) natural gas pipeline project in northern British Columbia.

The closures increase environmental, social and governance (ESG) risks for TC Energy Corporation's (Baa2 stable) CGL project, increasing execution risk, a credit negative. The protests, resultant route closures and layoffs also highlight an ESG risk for CN, that is inherent to all Canadian businesses and operations that are adjacent to indigenous lands and territories.

The blockades are credit negative for CN because it is unable to move trains through a key transportation corridor connecting western and eastern Canada. The recurring blockades have forced CN to cancel more than 400 trains since they began. A blockade near Belleville, Ontario is on CN's only eastern link between western and eastern Canada. In addition to the temporary lay offs to combat lost revenue, one of CN's unions has said that up to 6,000 employees across the entire company could be affected.

The lost revenue will negatively affect CN's operating profits and we expect the operating margin will see some deterioration in the first quarter of 2020, with the severity of the deterioration depending on the time it takes to remove the blockades. An eight-day strike in fourth-quarter 2019 halted the majority of CN's service during that time. Credit metrics were little changed, and we expect the same during the blockade because of the strength of CN's liquidity and cash flow profile.

The protests and blockades are also credit negative for TC Energy because it increases project execution risk. Earlier this month, the Royal Canadian Mounted Police enforced a court injunction, clearing obstacles and making arrests so that construction could continue on the pipeline. CGL has signed agreements with all 20 elected indigenous bands along the route, but some hereditary chiefs do not support it.

TC Energy has signed agreements to sell 65% of the pipeline and expects to put in place a secured credit facility to fund up to 80% of the project's capital expenditures during construction. These agreements and the credit facility, along with the receipt of cash to cover carrying charges during construction, limit the company's exposure to the project relative to its roughly CAD9-CAD10 billion in EBITDA. TC Energy may also sell up to a 10% interest in the project to the 20 First Nations that have agreements with CGL on similar terms to the initial 65% sale.

Although we expect TC Energy to equity account for its interest in CGL, and we believe the secured credit facility will be non-recourse to TC Energy and not reported as debt in its audited consolidated financial statements, we expect to proportionately consolidate its interest in the project when analyzing the company's financial profile. Given the elevated execution risk, we will not reflect earnings from CGL in our projections until the pipeline is in service.

The CAD6.6 billion pipeline will provide natural gas to LNG Canada's liquified natural gas export facility, which is under construction in Kitimat, British Columbia, at a total project cost of more than CAD40 billion (including CGL). The CGL has a planned route of 670 kilometers and an initial capacity of 2.1 billion cubic feet per day and may be expanded to 5.0 billion cubic feet per day.

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Carrefour's purchase of Brazilian cash-and-carry stores is moderately credit negative

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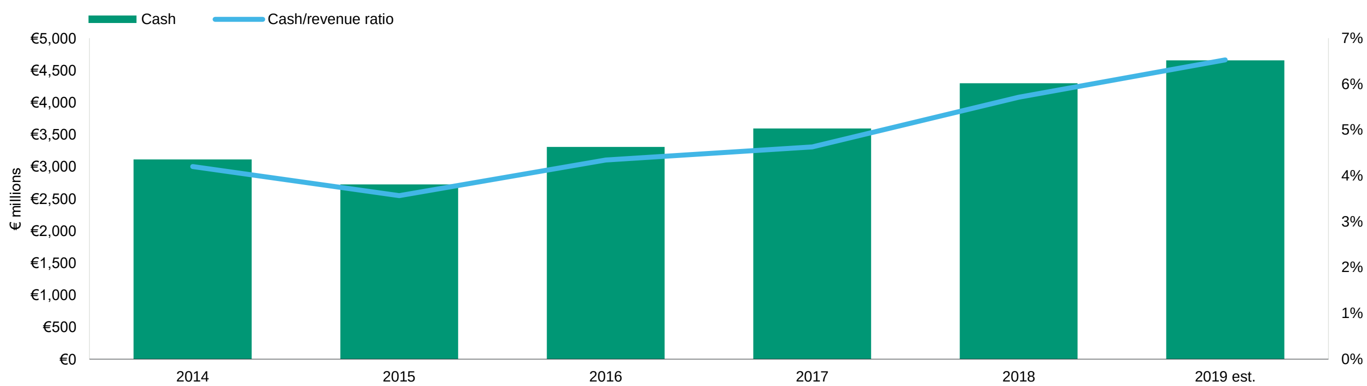
On 17 February, French retailer Carrefour S.A. ((P)Baa1 negative) announced the purchase of 30 Brazilian cash-and-carry stores from domestic rival Makro Atacadista S.A. for BRL1.950 billion (€420 million). The transaction will be financed with cash so it will not deteriorate Carrefour's Moody's-adjusted gross debt/EBITDA ratio, which we estimate was around 3.6x at year-end 2019, a high level for the current Baa1 rating. However, net debt will increase, a credit negative. The acquisition still requires the approval of Brazil's antitrust authority.

Carrefour had a higher-than-usual cash position at the end of 2019 that we estimate was around €4.5 billion, around €800 million higher than the average for the 2016-18 period (see exhibit).

Carrefour had a historically high estimated cash position at the end of 2019
Reported cash and cash equivalents



Source: Carrefour

Still, we assumed previously that Carrefour will use its excess cash to repay debt maturities and not to finance acquisitions.

Based on a full-year consolidation of the Makro stores, we forecast that Carrefour's retained cash flow/net debt ratio will reach around 30% in 2020 on a Moody's-adjusted basis, compared with our previous estimate of 32% and an expectation of at least 25% for the rating category. At the same time, Carrefour's Moody's-adjusted gross debt/EBITDA ratio would decline to 3.3x in 2020 from 3.6x in 2019 on the back of moderate earnings growth in Europe and Brazil.

Based on 2019 levels, the acquisition will add initially €600 million of revenue to Carrefour Brazil and strengthen its leading position. Effects on geographic diversity will be moderate though because, pro forma the transaction, the Brazilian subsidiary's contribution to group revenue will rise by only one percentage point to 18% based on 2019 figures, although Carrefour believes it could boost the new stores' sales by more than 60% by converting them to its Atacadão banner, translating into roughly €1 billion of additional sales. Carrefour's cash-and-carry operations are performing well, with a reported like-for-like growth of 5.5% in the fourth quarter of 2019.

A growing presence in Latin America, a region whose recurring EBIT margin was for Carrefour 440 basis points higher than that of France in 2018, will increase the group's results but will not materially strengthen its overall profitability. We forecast a Moody's-adjusted EBITDA margin of 5.4% in 2020, compared with our estimate of 5.1% in 2019, mostly because of the positive effects of the company's 2022 transformation plan.

While the trend is positive, Carrefour's profitability will remain both below that of its peers Tesco plc (Baa3 stable) and Koninklijke Ahold Delhaize N.V. (Baa1 stable) and the 6% EBITDA margin level commensurate with the Baa1 rating.[1] As a result, it is unlikely to generate significantly positive Moody's-adjusted free cash flow over the next 12 months.

Endnotes

1 See Carrefour and Casino keep losing market share, a credit negative, 17 February 2020.

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LendingClub's bank acquisition will provide the fintech with deposit funding, a credit positive

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On 18 February, LendingClub Corp. announced an agreement to buy Radius Bancorp in a deal that will give the San Francisco-based financial technology firm (fintech) the bank charter it has sought. The $185 million stock-and-cash transaction, which has a 12- to 15-month expected period for regulatory approval, will give LendingClub access to deposit funding, a lower cost and more stable funding source, versus its current market and wholesale funding, a credit positive for the company and its securitizations. In addition, the acquisition will reduce costs as well as legal and regulatory uncertainties because LendingClub will no longer utilize a bank partner to fund the loans it arranges.

LendingClub focuses on online, consumer marketplace lending – mostly unsecured personal loans, and has $3.0 billion in assets. Loan originations were $3.1 billion in the fourth quarter of 2019, and volumes have been increasing, although they are a very small share of the approximately $4 trillion non-mortgage, consumer lending market. By acquiring Radius Bank, a $1.4 billion asset digital banking company, LendingClub will start to offer digital banking services such as checking and savings accounts. The lack of legacy systems and smaller platforms make fintech online lenders such as LendingClub more nimble than many established rivals: traditional bank and nonbank lenders continue to play catch-up to match the value-added services that online lenders provide.

The acquisition will allow LendingClub to leverage its existing technology and suite of lending products with lower cost and more stable funding. Marketplace and wholesale funding is more expensive than bank deposits, with companies also facing funding constraints during times of uncertainty when such confidence-sensitive funding can become unavailable.

LendingClub's profitability is constrained, with the company reporting net losses for the past three years, including a $31 million loss for 2019. In addition to the benefit of lower funding costs, the acquisition will allow LendingClub's expenses to decline because it will no longer have to share its revenue with its partner bank, WebBank. LendingClub estimates that this new model will save it $25 million annually. However, higher bank compliance costs will likely partially offset this cost savings.

Nonbank lenders that utilize partner banks such as WebBank to originate loans believe their loans benefit from federal "rate exportation" laws, under which banks can offer loans with interest rates that exceed the maximum otherwise allowed by state law. However, recent court cases have called into question whether such loans are indeed exempted from state usury laws. Upon closing of the acquisition, LendingClub's legal and regulatory uncertainties should decline as it will benefit from bank federal preemption of state usury laws. Furthermore, while nonbank lenders such as LendingClub are subject to state and federal lending laws as well as oversight by the US Consumer Financial Protection Bureau, they are not subject to the credit-positive safety and soundness regulatory oversight to which banks are subject, including capital, liquidity, transparency and risk management requirements.

Many online lenders opt to sell newly originated loans given their higher cost, and less stable funding, which generates a high proportion of nonrecurring, gain-on-sale revenue. As a result, quarterly earnings tend to be volatile owing to the dependence on that quarter's origination volume. Currently, only 11% of LendingClub's earnings are recurring. The company has stated that it aims to increase that amount to 30% by holding more loans on its balance sheet after completing the acquisition, a credit positive because it would likely generate more stable earnings.

The acquisition will also be credit positive for LendingClub's securitizations. Future securitizations would benefit if LendingClub no longer uses a partner bank to originate personal loans because cash flow risks from legal and regulatory uncertainties would decline. Such risks will remain in place for existing securitizations, the underlying loans of which were originated by a partner bank. In addition, LendingClub's improved financial profile, and the increased regulatory oversight that comes with a bank charter, would benefit LendingClub's outstanding securitizations by reducing the risk of disruptive servicing transfers.

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Brazil's large retail banks will lose fee income to central bank's new instant payment system

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On 19 February, Brazil's central bank announced the implementation timeline for its new Pix instant payments ecosystem, and made joining it obligatory for banks and payment companies with a minimum of 500,000 active accounts or clients. The Pix system is credit negative for Brazil's large retail banks because it will reduce the fee income banks earn from cash transfers and card payments processing.

Brazil's largest retail banks earn fees from various payment processes, including fixed fees for cash transfers or payments, merchant discount rates for payment acquirers, interchange fees for card issuers, fees from sales and rentals of point-of-sale units, fees from prepayment of credit card receivables, and annual credit card fees. Pix's cheaper and time-efficient alternative digital payment method will make it a direct competitor for existing payment systems including same day transfers (TED) or debit and credit card payments. PIX will launch later this year and will target peer-to-peer. business-to-business, and government services through a smartphone banking application. Although banks will be able to charge for instant transfers via the new system, increased competitive pressures will make PIX fees lower than the total combination of fee streams banks currently earn.

Brazil's largest banks do not uniformly publish their fees from various types of payment processing. However, we estimate that the take rate, total fees divided by payments volume, for card payments processing on a systemwide basis at year-end 2019 was 2.2% of around BRL1.5 trillion of volume. If between 10%-15% of total payment volume were to be lost to the PIX system then fees earned would fall on average by 4.3 billion (see exhibit). The greater the use of PIX versus traditional payment systems then the greater the loss in fee income will therefore be.

Banks' loss of payment processing fees to the PIX system could be significant

	Volume lost to Pix payments system (BRL billions)							
Fees earned by banks	100	150	200	250	300	350	400	450
0.0%	2.2	3.3	4.4	5.5	6.6	7.7	8.8	9.9
0.2%	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0
0.4%	1.8	2.7	3.6	4.5	5.4	6.3	7.2	8.1
0.6%	1.6	2.4	3.2	4.0	4.8	5.6	6.4	7.2
0.8%	1.4	2.1	2.8	3.5	4.2	4.9	5.6	6.3
1.0%	1.2	1.8	2.4	3.0	3.6	4.2	4.8	5.4

Loss of fees is relative to a total take rate of 2.2%
Source: Moody's Investors Service

The Pix system will work on a 24/7 basis year-round, and all banks and payment companies, including fin techs, with 500,000 clients or more will be required to join it, affecting the vast majority of retail banks and particularly the largest ones that dominate the traditional payments system.

PIX users will be able to effect instant payments and transfers by using QR codes, key information such as their tax identification number (cadastro do pessoa fisica) or by manually inputting data. The central bank will keep records of the database behind the instant payments system (sistema de pagamentos instantaneos) and banks will be able to use reserve requirements that are kept for demand deposits as well as posting collateral to access a special facility (linha de redesconto) with the central bank to ensure they have sufficient liquidity for instant payment settlement. Several banks have already developed instant payment technologies but they rely on participants being their customer and the fees charged on these transfers are around 1%. The PIX system will allow bank-to-bank settlement, which has broader potential use than existing instant payment apps.

The PIX system is part of the central bank's financial development and inclusion program. It provides a regulatory boost toward cementing a new channel for payments in line with the central bank’s efforts to increase digitization and efficiency in money transfers and payments. PIX would also reduce the use of cash, which would reduce security and transport costs in the Brazilian banking system. However, PIX comes as the country's low interest rates and increased competition test banks' pricing power and profitability. Intense competition among card payment acquirers has reduced net merchant discount rates and rates on prepayment of credit card receivables, despite increasing volume growth.

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Morgan Stanley's agreement to acquire E*TRADE is credit positive for both firms

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On 20 February, Morgan Stanley (A3 review for upgrade) announced that it had agreed to acquire E*TRADE Financial Corp. (E*TRADE, Baa2 review for upgrade) in a $13 billion all-stock transaction. The business combination is credit positive for each firm, and we put both Morgan Stanley and E*TRADE on review for upgrade following the announcement.

Acquiring E*TRADE will tilt Morgan Stanley's business mix towards wealth management, a more stable and lower-risk source of profitability than its inherently more volatile capital markets' activities. (Nevertheless, Morgan Stanley's capital markets business a strong franchise and has performed well in the face of industry-wide revenue pressure.) Following the integration of E*TRADE into its wealth management business, Morgan Stanley's wealth and investment management segments would account for approximately 57% of its total pretax income (excluding potential acquisition-related synergies), compared with 51% in 2019. From E*TRADE's perspective, the credit profile of its combination with higher-rated Morgan Stanley would be stronger than E*TRADE on a standalone basis.

By seeking to expand and enhance its wealth management franchise, Morgan Stanley has once again strongly demonstrated its commitment to its long-held core strategic priorities. The careful stewardship of its senior leadership team has strengthened its financial performance, evidenced by a trend of improved profitability and favorable capital and liquidity positions that substantially offset challenges posed by its heavy reliance on market funding. The on-boarding of E*TRADE's approximately $56 billion of customer deposits would improve Morgan Stanley's funding structure.

There are attractive business development opportunities in combining Morgan Stanley's and E*TRADE's services across the broad spectrum of their respective financial advisory and self-directed investor categories, and in their workplace stock plan management activities. Morgan Stanley did not model specific revenue synergies in its announcement, but nevertheless expects to grow revenue and improve its wealth management profit margins above 30%, from 27% in 2019. There are also substantial cost-saving opportunities available in combining and consolidating personnel, systems and physical locations.

Morgan Stanley expects to acquire E*TRADE in the fourth quarter of 2020, subject to receiving regulators' and E*TRADE's shareholders' approvals.

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EU cites Panama for lax transparency on tax controls, a credit negative for banks

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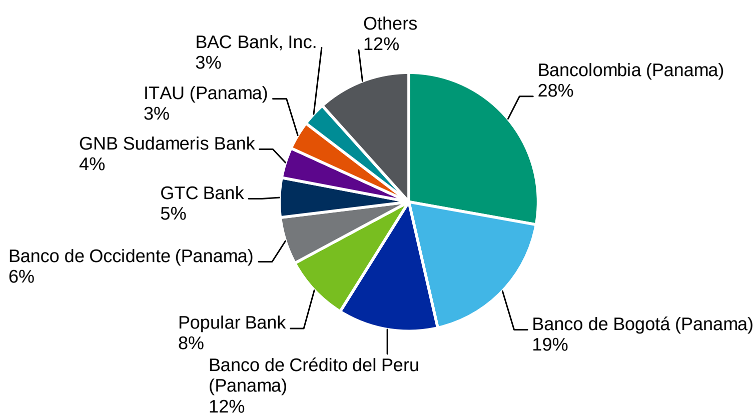
On 18 February, the Council of the European Union added Panama back to its list of countries of non-cooperative jurisdictions for tax purposes, after just removing it from the same list in 2018. The list reflects a country's lack of full compliance with EU criteria on the transparency and exchange of information for tax purposes and some European funds are barred from transiting funds through a listed country's financial system. Panama's re-inclusion on the list is credit negative for banks, and especially the offshore banking segment, which is mainly funded by foreign investors.

Foreign investors are particularly sensitive to repricing and refinancing risk. If foreign investors avoid or are not allowed to utilize Panama's offshore banking segment, it would pressure the banks' profitability and may limit their business growth. Panama's onshore banks are basically domestically funded, so the country's inclusion on the list may have a lower effect on their business and operational activity.

As of November 2019, there were 23 offshore banks in Panama and their assets comprised about 14% of total onshore and offshore banking system assets. As shown in the exhibit, most of the country's offshore banking activity is concentrated in affiliates of Latin American banks and other financial institutions, including Bancolombia (Panama), Banco de Bogotá (Panama), Banco de Crédito del Perú (Panama) and Popular Bank, which together account for more than 67% of the offshore banking assets.

Panama's offshore banks as of November 2019



Sources: Superintendencia de Bancos de Panamá and Moody's Investors Service

Since the Panama-Papers were published in 2016, international financial regulators have been inspecting Panama's fiscal and legal systems. Panamanian authorities have since worked to improve financial and fiscal regulation, and the government has said it will work with international authorities to avoid having a reputation as a country with weak regulatory standards. Nevertheless, the European Commission in February 2019 and the Financial Action Task Force (FATF) in June 2019 each cited Panama for deficient anti-money laundering and anti-terrorist financing standards.

The EU's relisting of Panama as a non-cooperative jurisdiction for tax control will again raise the international financial community's scrutiny of Panama's offshore banking system operations and relationships with international correspondent banks, an essential element for the payments system given the country's fully dollarized economy.

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European banks will continue to issue MREL-eligible debt, a credit positive

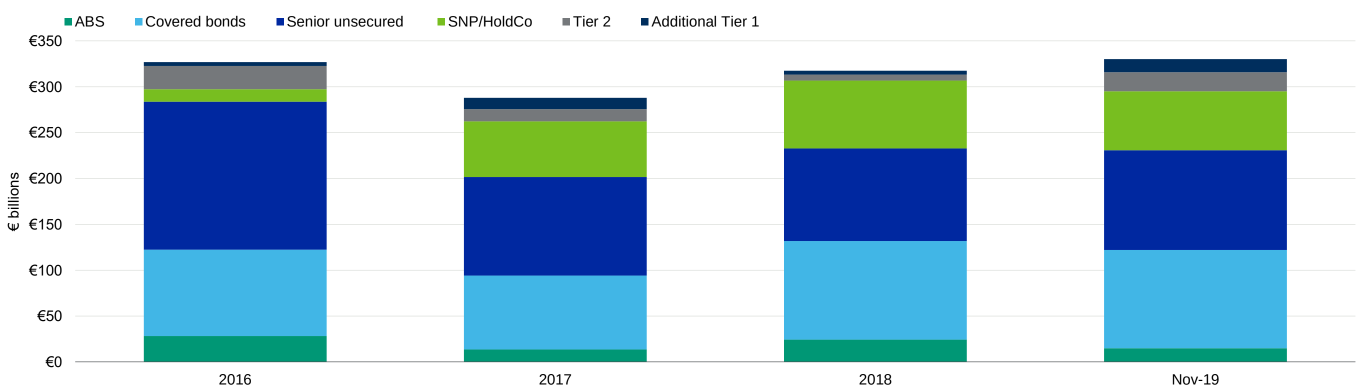
Originally published on 20 February 2020

On 17 February, the European Banking Authority (EBA) published a quantitative report on minimum requirements for own funds and eligible liabilities (MREL) that shows resolution authorities have made strong progress in agreeing to resolution strategies and setting related MREL requirements. However, the report also said that European banks must issue €178 billion of MREL-eligible debt to close their MREL shortfall, a credit positive because the banks will continue to improve their loss-absorption capacity.

Since the introduction of MREL in January 2016, European banks have made some progress in issuing MREL-eligible debt[1], as shown in Exhibit 1. At the end of June 2019, banks had issued a total of €187 billion of this type of debt, which roughly equals the estimated shortfall.

Exhibit 1

Long-term debt securities issued by European banks that are part of the EU28



ABS = Asset-backed securities; SNP/HoldCo = Senior non-preferred and holding company debt

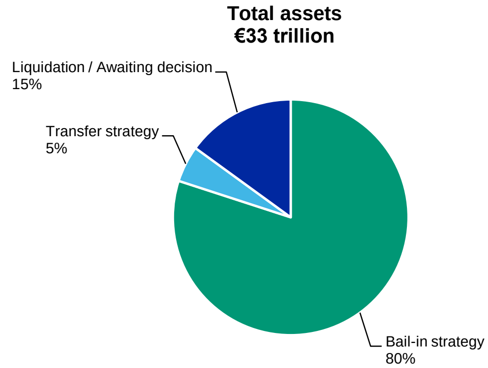
Sources: Dealogic, European Central Bank calculations and Moody's Investors Service

The EBA report estimates that 117 out of 222 banks for which a bail-in or transfer strategy has been decided[2] show an MREL shortfall totaling €178 billion. This means that close to half of the relevant banks already meet their MREL target. The shortfall has been calculated as the difference between the amount of MREL-eligible resources as per the relevant resolution authorities' policies at the end of December 2018 and the requirement banks must meet at the end of their transition period.

The EBA added that 65 of the 117 banks with an MREL shortfall also report holding so-called other marketable securities totalling €67 billion. These instruments are close in nature to MREL-eligible debt but are not eligible for a variety of reasons (location, law of issuance or maturity). Consequently, these banks will not need to issue completely new types of debt but can partly roll over existing debt. It also shows that these banks already have a sophisticated investor base that is likely to invest in long-term unsecured debt.

The most commonly applied resolution strategy for European banks is bail-in (80% of total European Union domestic assets), while transfer is the preferred option for only 5%, as shown in Exhibit 2. Bail-in is the preferred strategy for the largest banks, while the transfer strategy is mostly for banks limited in size (total assets lower than €20 billion).

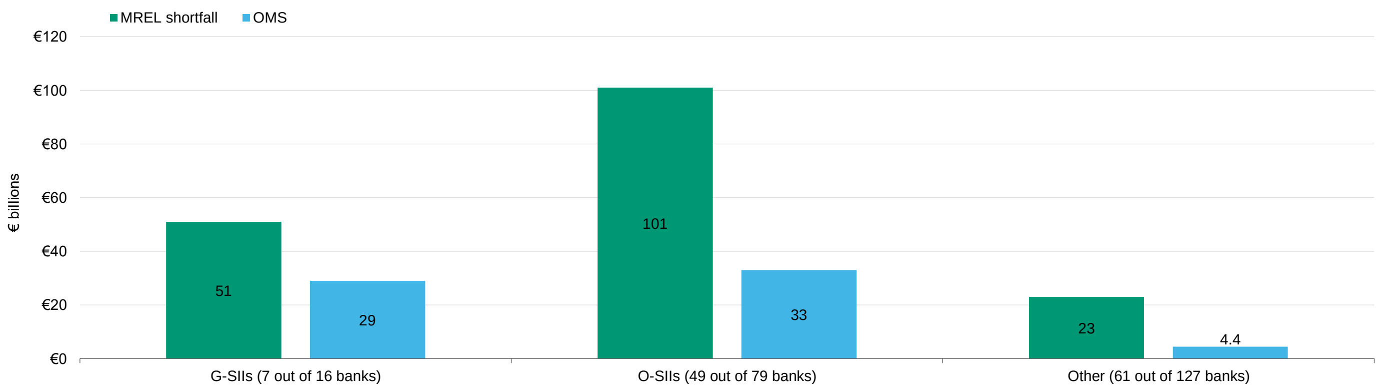
Exhibit 2
Resolution strategies for European banks



Sources: European Banking Authority and European Central Bank

The EBA-calculated shortfalls vary depending on the type and size of the bank and its resolution group. Thus, larger banks have a lower shortfall on a relative basis than smaller institutions, as shown in Exhibit 3.

Exhibit 3
MREL shortfall for European banks



OMS = Other marketable securities
Source: European Banking Authority

In the report, the EBA encouraged banks to take advantage of positive market conditions to issue MREL eligible debt. We believe that banks will be able to fill the MREL shortfalls given that full compliance with MREL requirements is not until year-end 2023.

Endnotes

1 Commonly senior non-preferred debt, Tier 2 debt and Additional Tier 1 instruments.

2 Twenty-two banks have been excluded because of data quality issues.

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Single Resolution Board consultation on changes to its MREL policy is credit positive

Originally published on 20 February 2020

On 17 February, the Single Resolution Board (SRB) launched a public consultation on changes to its minimum requirement for own funds and eligible liabilities (MREL) policy to take into account provisions introduced by the last Banking Package. The consultation is credit positive because it provides a more refined view on how MREL will be applied to the banking groups under SRB's remit.

The proposed MREL policy under the Banking Package,[1] although more refined, still provides the SRB with a meaningful degree of discretion when assigning the final MREL requirements to a resolution group. This will provide flexibility to properly address idiosyncratic situations. However, the final calibration of each group's requirements must be carefully balanced to ensure consistency.

The document introduces changes to the calibration of MREL, including a new leverage-based MREL target (based on the so-called leverage ratio exposure measure), which banks will have to comply with in addition to the one based on risk-weighted assets (RWAs). This is similar to regulatory capital requirements with a risk-weighted measure and a leverage measure used as a backstop. The proposed document also considers some new conditions under which the recapitalisation amount can be adjusted.

The policy also includes some further refinement of the MREL requirements for groups with multiple resolution entities (the so-called multiple point of entry approach). In particular, the SRB proposes adjusting the multiple point of entry requirement on the basis of a hypothetical single point of entry requirement, which is the SRB's default approach. This would be done on a case-by-case basis to foster a level playing field across resolution strategies.

Regarding subordination, the policy proposes to divide banks into two different groups, Pillar 1 banks [2] and non-Pillar 1 banks. The first group would be subject to a subordination requirement of 18% of RWAs (plus the combined buffer requirement) or 6.75% of leverage ratio exposure for global systemically important institutions (G-SIIs). For top-tier banks and other Pillar 1 banks, there would be a subordination requirement of 13.5% of RWAs (plus the combined buffer requirement) or 5% of leverage ratio exposure. These subordination requirements are higher than the current approach for G-SIIs, which is 16% of RWAs plus the combined buffer requirement, and lower in the case of other systemically important institutions, currently 14% of RWAs plus the combined buffer requirement.

In addition, Pillar 1 banks would have to ensure that subordinated MREL resources are equal to at least 8% of total liabilities and own funds, although resolution authorities have the option of adjusting on a case-by-case basis. For top-tier 1 banks, this 8% target level is capped at 27% of RWAs only in cases where access to the Single Resolution Fund is not considered to be an option for resolving that resolution entity in the resolution plan.

The second group, non-Pillar 1 banks, would be subject to a subordination requirement only by a decision of the resolution authority to avoid a breach of no-creditor-worse-off principles.

The proposed policy also expands the scope of subsidiaries for which the SRB will set internal MREL requirements. The SRB proposes to consider all subsidiaries meeting a 4% threshold of the resolution group's total risk exposure amount, or leverage exposure, or total operating income. The current threshold is 5%.

Lastly, the policy establishes a common deadline for banking groups of 1 January 2024 to comply with external and internal MREL targets, including subordination. The document also proposes setting two intermediate targets, a first binding target to be met by 1 January 2022 and a second target of informative nature for 1 January 2023.

Endnotes

1 On 26 February 2019, the European Union reached a political agreement on a package of legislation aimed at further strengthening the region's large banks.

2 This group includes global systemically important institutions, banks with total assets of over €100 billion and other banks deemed likely to pose systemic risk in the event of failure.

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HSBC's successful restructuring of underperforming businesses would be credit positive

Originally published on 19 February 2020

On 18 February, HSBC Holdings (A2 negative, a2[1]) announced its most radical overhaul in years, which if successfully executed will eventually deliver credit positive results for the group.

The new plan aims to restructure underperforming parts of the business in the US and the non-ring-fenced bank (NRFB) in Europe and the UK, reallocate capital from the Global Banking and Markets division to growth opportunities predominantly in retail and in fast-growing Asian markets, and reduce the cost base and simplify the business, raising the group's efficiency.

If successfully executed, the ambitious plan will increase HSBC's return on tangible equity (RoTE) to a target of 10%-12% in 2022 from 8.4% in 2019, with the group's Common Equity Tier 1 (CET1) ratio remaining above 14% over the period. However, during 2020-21 the group is likely to have reduced internal capital generation capacity as it works toward these goals. This execution risk, along with macroeconomic pressures on the group's profitability are reflected in the negative outlook on HSBC's ratings.

» **The target RoTE of 10%-12% will be accomplished through capital reallocation.** The group will restructure its US operations and the NRFB in Europe and the UK, particularly in Global Banking and Markets (GB&M). It aims to reduce the gross risk-weighted assets (RWAs) of these businesses by $100 billion by end-2022 and reallocate the RWAs in high-performing franchises, particularly in Asia.

» **Cost cuts and simplified organisation will raise the group's efficiency.** HSBC's cost programme targets savings of around $4.5 billion, equal to around 14% of the 2019 cost base. The group targets adjusted costs at or below $31 billion in 2022, a 10% decrease on an inflation-adjusted basis.

» **Capital will be maintained at current high levels.** The group targets a CET1 ratio of above 14% during the restructuring period and towards the top end of a 14%-15% range at end-2022, in line with the 14.7% ratio reported at end 2019.

» **Factors beyond management's control may introduce greater execution risk than presently anticipated.** These include weaker economic growth, the continued low interest rate environment, US-China trade tensions, social unrest in Hong Kong and the impact of the coronavirus epidemic. HSBC maintains conservative revenue assumptions, with a modest decrease in 2020 and low single-digit growth in 2021-22, but a severe shock to the operating environment could amplify the risk of a sharp revenue drop.

HSBC has embarked on a radical restructuring because the group has been unable to generate sufficient returns on capital or assets despite its strong foothold in Asia and deep global and domestic franchises. Previous simplification and cost initiatives were insufficient to address weaknesses in some of its core businesses, which this more ambitious plan is aiming to address. Supported by strong capital and liquidity, the plan – if successfully delivered – would be credit positive.

HSBC's target RoTE of 10%-12%, a credit positive improvement from 8.4% in 2019, will be mostly accomplished by restructuring underperforming businesses and reallocating RWAs. In particular, the group will reduce the gross RWAs of the NRFB in Europe and the UK and its US operations (see exhibit) by about $100 billion by end 2022. Most of the RWA reduction will come from the Global Banking and Markets (GBM) division, for which RWAs are targeted to decrease by around 35%, bringing the contribution of the GBM division to less than 25% of group RWAs in 2022 from 31% in 2019. These RWAs will then be reallocated to high-performing franchises, predominantly Asian retail banking and wealth management, which have greater growth and earnings potential and serve as a shock absorber for the remaining capital markets business of the group, a credit positive.

Both the NRFB in Europe and the UK and the US businesses are underperforming
Main P&L and balance sheet items

(adjusted)	NRFB in Europe and the UK	US
Revenue	$7.8 billion (-3% yoy)	$4.7 billion (-3% yoy)
PBT	$0.8 billion	$0.6 billion (-39% yoy)
Cost : income ratio	95%	84%
RoTE	0.6%	1.5%
RWAs	$166 billion	$89 billion
Leverage exposure	$755 billion	$249 billion
GBM division		
PBT	$176 million (-80% yoy)	$470 million (-24% yoy)
RWAs	$105 billion	$37 billion
RBWM division		
PBT	$276 million	$259 million loss

Source: HSBC

The restructuring of HSBC's GBM business is credit positive because its aims to tighten both the product and customer focuses, which at present are too broad for a firm of HSBC's scale. The RWA consumption of some capital markets products is too high relative to returns, and many corporate relationships are insufficiently profitable.

The group will reduce capital deployed in the rates business and exit G10 long-term derivative market making in the UK, as well as reduce sales and research coverage in European Cash Equities to focus on supporting Equity Capital Markets. It will focus on connecting key international European clients with Asia and the Middle East and concentrate European investment banking activities on the UK mid-market and on capital flows and transactions between Europe and high-growth franchise markets. It will continue to invest in transaction banking and financing capabilities.

The restructuring of the US business into an "international client-focused corporate bank" would bring the US business more in line with HSBC's global franchise, which would be credit positive. The US business has a very liquid but low-yielding asset base and a higher cost deposit base than many US bank peers, resulting in a depressed net interest margin. This weakness is exacerbated by a high cost structure stemming in part from remediation initiatives taken to improve compliance and controls. The restructuring includes a plan to reduce total costs in the US by between 10% and 15%, driven by branch reductions in retail and consolidation of middle and back office operations in Commercial Banking and Global Banking.

» **US retail activities**. HSBC remains committed to retaining its US retail activities as a source of stable funding to support its transaction banking and trade finance activities, but will attempt to tie the business more closely to its retail business globally . The group will focus on more internationally oriented affluent/premier clients and de-emphasize its mass market, full-service retail banking strategy. In connection with this, the group has announced plans to reduce its US branch network of 224 by around 30%. It will integrate private and retail banking in the US into a single business line, mirroring a similar change at the group level. The group also intends to expand its unsecured lending in the US, which we believe could be challenging at this point in the credit cycle.

» **US commercial and wholesale activities**. Commercial Banking and Global Banking activities will focus on multinational corporate and institutional clients as well as mid-market enterprises leveraging the Group's global footprint and supported by its Debt Capital Markets, transaction banking and financing offerings. The group will consolidate select fixed income activity in London (US Global Markets RWAs will halve by around $5 billion, with the majority to be reinvested into commercial banking and retail banking). The group is also targeting a substantial reduction in its leverage exposure globally, a portion of which we believe will come from its US Global Markets business.

Other underperforming businesses

HSBC did not update on the potential sale of its French retail business, which has an unsustainable business model given its limited scale and weak profitability exacerbated by the low-rate environment. The French press recently reported that Groupe La Banque Postale and Société Générale (A1/A1 stable, baa2[2]) are interested in acquiring the business.

Endnotes

1 The ratings shown are HSBC's long-term senior unsecured debt and the Baseline Credit Assessment.

2 The ratings shown are Soc Gen's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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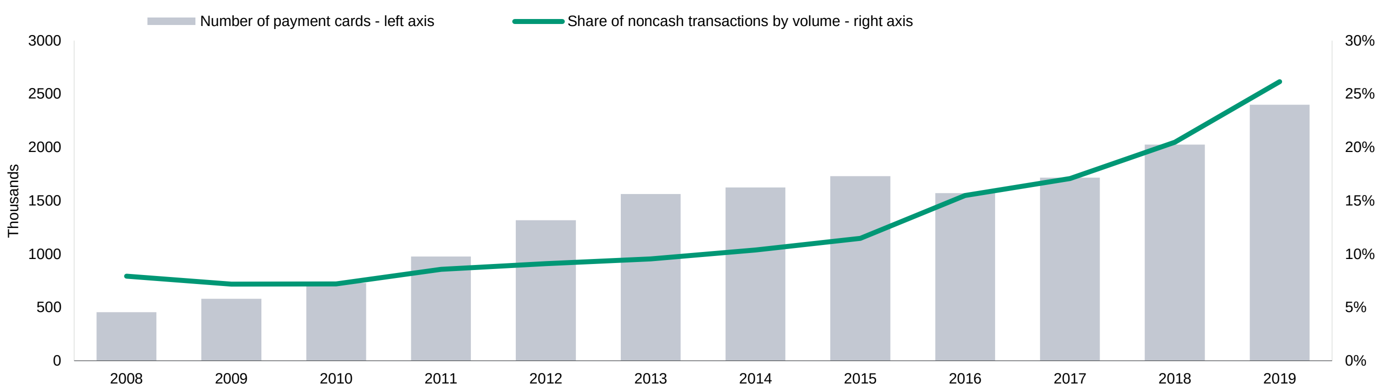
Rapid growth of noncash card transactions in Armenia is credit positive for banks

On 14 February, the chairman of the Union of Armenian Banks, Mher Abrahamyan, announced that noncash card payments in 2019 had increased 52% by volume in 2019 and 73% by number of transactions. Supporting the growth was an 18% increase in active cards to more than 2.4 million and a 34.5% increase in the number of card transactions to 64 million. The increased card transactions and number of active cards are credit positive for Armenian banks because they underpin the banking sector's fee and commission income, which is a stable recurring revenue source.

While the pace of noncash transaction growth is much faster than cash operations, noncash transactions' share of total payments volume was still modest at 26% (see Exhibit 1), leaving room for further growth. We expect noncash payment growth to continue, supported by growing penetration of point-of-sale terminals and e-commerce in Armenia.

Exhibit 1
The number of payment cards and the volume of noncash transactions in Armenia have been growing



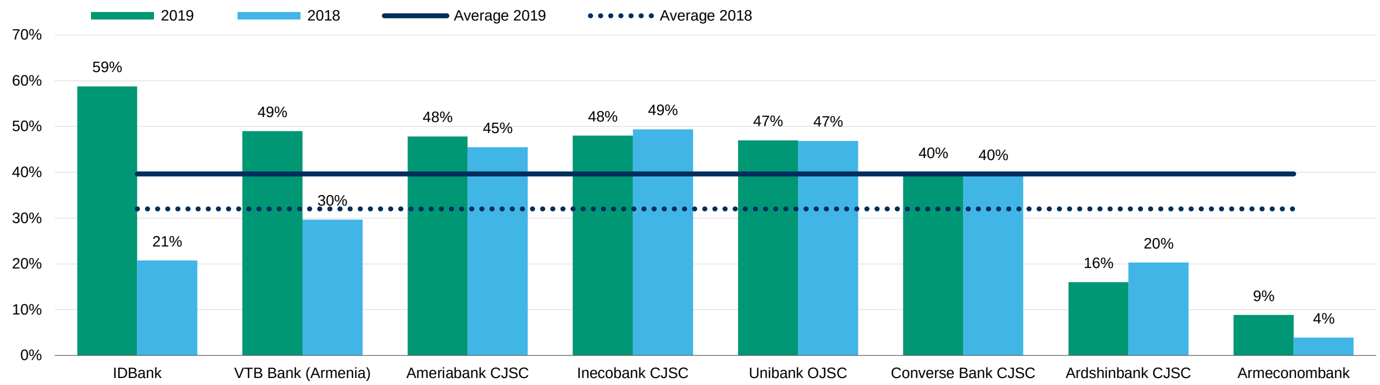
Source: Union of Armenian Banks

The main beneficiaries are banks whose fee income is largely fueled by fees from card issuance and transactions. Card maintenance and payments are the single largest source of fee and commission income for Armenian banks: on average, they accounted for 39% of rated banks' fee and commission income in 2019, up from 32% in 2018.

In particular, IDBank (B3 developing, b3[1]), VTB Bank (Armenia) (B1 stable, b3), Ameriabank CJSC (Ba3 stable, ba3) and Inecobank (Ba3 stable, ba3) reported a high share of fee and commission income from card transactions (see Exhibit 2).

Exhibit 2

Rated Armenian banks' card fees as a percentage of fee and commission income



Data for 2018 is based on year-end IFRS; data for 2019 is based on year-end IFRS for all banks except Ardshinbank and Armeconombank where third-quarter IFRS is used
Source: Banks' financials

Endnotes

1 The ratings shown in this report are the bank's domestic deposit rating and Baseline Credit Assessment.

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Setting up Islamic finance windows is credit positive for Uzbek banks

Originally published on 21 February 2020

On 18 February, Islamic Finance News reported that Uzbekistan's Asia Alliance Bank (AAB, B2 stable, b2[1]) has started discussions with the Islamic Corporation for the Development of the Private Sector (ICD, A2 stable) to set up an Islamic window (a division within a conventional bank to provide Shariah-compliant services) by the end of August 2020.

Opening an Islamic window will allow AAB and other banks in Uzbekistan, which have similar plans (Exhibit 1), to unlock the substantial growth potential in Islamic banking, which remains underdeveloped in Uzbekistan. Tapping this new, not yet competitive and potentially high-growth market segment will support the banks' profitability, and they will benefit from greater access to funding from Islamic development institutions.

Exhibit 1

Four banks in Uzbekistan have announced plans to open Islamic windows

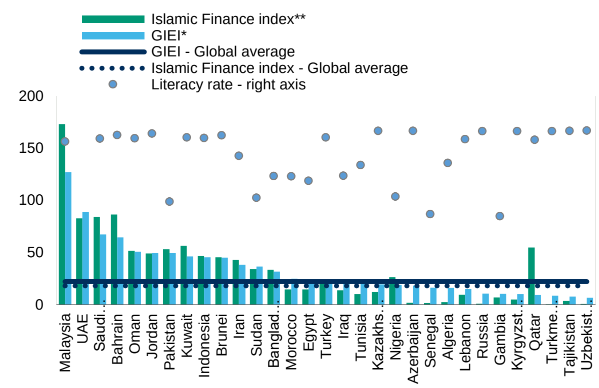
	Total assets as of 1 Jan 2020 (in UZS bn)	Market share as of 1 Jan 2020 (by assets)	Moody's Ratings (BCA, LT LC/LT FC, Outlook)	Return on average assets	Gross loans % due to customers
Turon Bank	5,979	2.2%	not rated	1.4%	189%
Kapitalbank	5,483	2.0%	b3, B3/B3 STA	1.5%	60%
Ipak Yuli Bank	5,327	2.0%	b2, B2/B2 STA	3.9%	138%
Asia Alliance Bank	2,259	0.8%	b2, B2/B2 NEG	3.0%	90%

Sources: Central Bank of Uzbekistan and Moody's Investors Service

Islamic banking is underdeveloped in Uzbekistan (Exhibit 2), as well as in the broader Commonwealth of Independent States (CIS). Despite the region's Muslim population of around 80 million, 36% of whom live in Uzbekistan (Exhibit 3), the absence of accommodating regulations and weak public awareness impede the Islamic banking sector's growth.

Exhibit 2

Uzbekistan has very low penetration of Islamic finance, despite a large Muslim population and 100% literacy rate

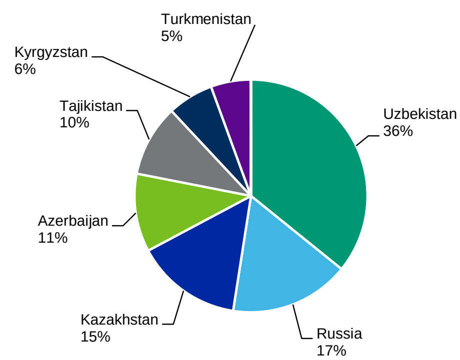


(*) The Global Islamic Economy Indicator (GIEI) is a composite-weighted index composed by Thomson Reuters and DinarStandard that evaluates and ranks 73 countries based on the overall quality of their Islamic economic ecosystem. Forty-nine different categories are used to compile the indicator, including supply/demand drivers relative to country size, governance and awareness, and to social considerations. (**) The Islamic Finance Indicator measures the quality of the Islamic finance industry through financial, governance, awareness & social and is one of the sub-indicators of the GIEI indicator.
Sources: World Bank and Thomson Reuters

Exhibit 3

Uzbekistan has the largest Muslim population in the CIS region

Muslim population by country



Percentages were calculated by applying Pew Research Center data on the proportion of Muslims in each country's total population as of the end of 2010 to the total population as of the end of 2018.
Sources: Pew Research Center and Moody's Investors Service

Uzbekistan's government, however, is currently developing legislation to govern Islamic finance, and the new framework will allow domestic banks to open Islamic windows. Government efforts will lead to significant expansion of Islamic finance in the coming years, building on Uzbekistan's demographic and cultural foundation.

Islamic Development Bank (IDB, Aaa stable) funding will be an important catalyst to build the domestic Islamic finance industry. The bank has launched a special funding programme to provide up to $6 billion to six countries in Central Asia, including Uzbekistan, during 2016-20. Until now, Uzbekistan's banks have only been intermediaries or agents distributing the funds to end-customers. Opening Islamic windows will improve these banks' access to IDB funding, giving them an opportunity to diversify their funding.

We further expect the more diverse funding will benefit the participating banks' profitability, as we have observed for Islamic banks operating in the Gulf Co-operation Council (GCC) countries, where Islamic banks report strong and higher net profit margins than their conventional peers (analogous to conventional banks' net interest margins). In turn, the difference in margins reflects Islamic banks' competitive advantage in attracting low-cost current and savings account balances, as well as their higher asset yields, given their focus on retail lending.

Endnotes

1 **The bank ratings shown in this report are the bank's deposit rating and Baseline Credit Assessment.**

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DP World's planned dividend to Dubai World will be credit positive for UAE banks

Originally published on 19 February 2020

On 17 February, United Arab Emirates (UAE)-based DP World PLC (Baa1 review for downgrade) announced that Port and Free Zone World FZE (PFZW), which owns 80.45% of DP World, made an offer to DP World minority shareholders to acquire the outstanding 19.55% of shares that it does not already own for around $2.7 billion. The transaction would give PFZW full ownership of DP World, which will then be delisted. PFZW and DP World will raise up to $9 billion of debt to buy out minority shareholders, pay a $5.15 billion dividend to Dubai World (the sole shareholder of PFZW) and refinance some upcoming debt maturities and DP World's $254.4 million of outstanding convertible bonds. The transaction awaits approval from regulators and relevant shareholders.

PFZW and DP World's planned $5.15 billion dividend to Dubai World will be credit positive for UAE banks because Dubai World will use it to repay around $5 billion of the nearly $11 billion in restructured debt that it owes to UAE banks and international investors. The terms and probability of repayment for the balance of Dubai World's debt remain uncertain.

We expect varying credit-positive effects among creditor banks depending on whether and how much they contribute to financing the new $9 billion of PFZW debt guaranteed by DP World. For creditor banks that do not extend financing to DP World, the debt repayment would result in a net reduction in their exposure to the Dubai World Group, which is credit positive. For creditor banks that decide to extend financing to DP World in an amount similar to their expected repayment from Dubai World, the operation would effectively improve their credit position by moving their claims to DP World, the cash-generating operating company, from Dubai World, the non-income-generating holding company. We expect this to be temporary and followed by a net reduction in banks' exposure to the Dubai World Group, given that DP World has the intention to refinance a portion of the $9 billion debt in the debt capital markets at a later stage.

The differences in creditors' gross exposure, carried provisions and agreements will also vary the effects of the planned repayment for creditor banks. Disclosures about banks' exposure to Dubai World are limited, but we estimated in 2015, when Dubai World restructured its debt for a second time, that UAE banks held about 40% of around $11 billion of its total debt, compared with UAE systemwide total assets of $840 billion as of December 2019. We believe that Emirates NBD PJSC (A3/A3 stable, ba1[1]), which had $186 billion of total assets as of December 2019, is among Dubai World's largest domestic creditors. In 2014, ENBD reported a $2.3 billion exposure to Dubai World, which we believe has subsequently modestly decreased through amortisation.

Because of the planned delisting of DP World, a payment of $5.15 billion from PFZW to Dubai World is required for Dubai World to discharge its outstanding obligations to bank lenders, in line with the existing Dubai World creditor agreements.[2]

UAE banks have a challenging operating environment: OPEC production cuts constrain hydrocarbon economic growth, while slowing global trade, moderate oil prices, strong currency and geopolitical tensions weigh on the non-hydrocarbon economy. We expect weakening loan performance as corporates encounter lower business volume and margin compression, and personal borrowers' wage growth is limited. The ongoing renegotiation and restructuring of substantial amounts of UAE corporate debt will limit reported problem loan formation, but noticeably increases potential problem loan formation.

The dividend and minority buyout will significantly weaken DP World's credit metrics because it will guarantee the debt raised by its immediate parent company PFZW. We estimate that DP World's pro forma gross debt will increase to around $24 billion from $14 billion as of June 2019. We estimate that pro forma leverage, as measured by funds from operation to debt, will weaken to around 10% from 17% as of the last 12 months that ended June 2019. The transaction substantially deviates from the company's stated financial policies, showing its greater appetite for leverage and negative interference from debt-burdened Dubai World, which had previously limited its demands on DP World's cash flows to a moderate dividend.

On 17 February, we put DP World's Baa1 issuer and senior unsecured ratings on review for downgrade.

For the sovereign, improved visibility about repayment for a portion of Dubai World's legacy debt is credit positive. By lowering the remaining stock of restructured debt held at the non-income-generating holding company level, rollover risk for the remaining Dubai World debt and the associated contingent liability risk for the government of Dubai should decline. Nonetheless, these benefits may come at the expense of reduced transparency and more limited public disclosure because of DP World's delisting.

Endnotes

1 The bank ratings shown in this report are ENBD's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

2 For details on the 2011 and 2015 debt restructurings, please see Dubai World's second debt restructuring is credit positive for the UAE banking system and Emirates NBD, 2 February 2015.

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Swiss Re's insurance tie-up with IKEA shows value of its iptiQ white label insurance platform

Originally published on 20 February 2020

On 18 February, reinsurer Swiss Reinsurance Company Ltd (Swiss Re, Aa3 stable) said its iptiQ white label insurance subsidiary had entered a partnership with furniture retailer IKEA to offer home insurance to its customers under the HEMSÄKER brand, initially in Switzerland and Singapore. The agreement demonstrates iptiQ's capacity to give Swiss Re access to a greater share of the insurance value chain, and to generate lower-risk personal lines business that diversifies the reinsurer's traditional large commercial exposures.

We do not expect iptiQ to have a material effect on Swiss Re's overall business profile in the near to medium term given its small size. However, increased diversification of earnings streams that reduces earnings volatility is credit positive for the group.

Rising awareness and takeup of the iptiQ platform will add to pressure on some direct insurers facing competition from retail brands, which are increasingly focused on selling insurance to their customers. While we do not expect iptiQ and other white-label platforms to have a significant impact on direct insurers in the short term, incumbents could over time face margin erosion, or in some cases even displacement from the market, if white label insurance offerings are widely adopted by retail brands. This follows Tesla Inc.'s (B3 long-term issuer rating stable) recent announcement of future plans to expand its motor insurance offering through its own insurance subsidiary.

iptiQ illustrates how disruption of the traditional insurance business model can come from within the sector. The company allows brands that might want to sell insurance to overcome the regulatory and cost burden associated with forming and operating an insurance carrier, while also providing access to Swiss Re's risk selection capabilities and capital support through reinsurance. Moreover, the platform lends itself to bancassurance propositions, with Dutch lender ING Bank N.V. (Aa3/Aa3 stable, baa1[1]) listed as one of iptiQ's banking clients.

iptiQ's cutting-edge technology platform with full digital capabilities is also appealing to incumbent insurers that want to enhance the capabilities of their own offerings, without investing in their own new technology. iptiQ therefore provides Swiss Re with another means of serving insurers, with AIG Direct and Mapfre among the insurers that use the iptiQ platform. The HEMSÄKER home insurance offering illustrates the significant flexibility available through the iptiQ platform that the technology systems of many traditional insurers do not offer. For example, in Switzerland, HEMSÄKER customers can choose to modify their level of coverage so that they only pay for what they need, and can cancel the policy at any time.

While iptiQ is still very small relative to the broader group, generating $211 million in gross written premium during 2019, it is growing rapidly (estimated 92% CAGR from 2017 to 2019) and is a key component in the group's strategy to secure access to diverse risk pools. The granular personal lines insurance business that Swiss Re has access to through iptiQ is also lower risk relative to the group's reinsurance and commercial lines property and casualty businesses, which are inherently more volatile because of the extent of its catastrophe and long-tailed casualty line exposures.

Endnotes

1 The bank ratings shown are the bank's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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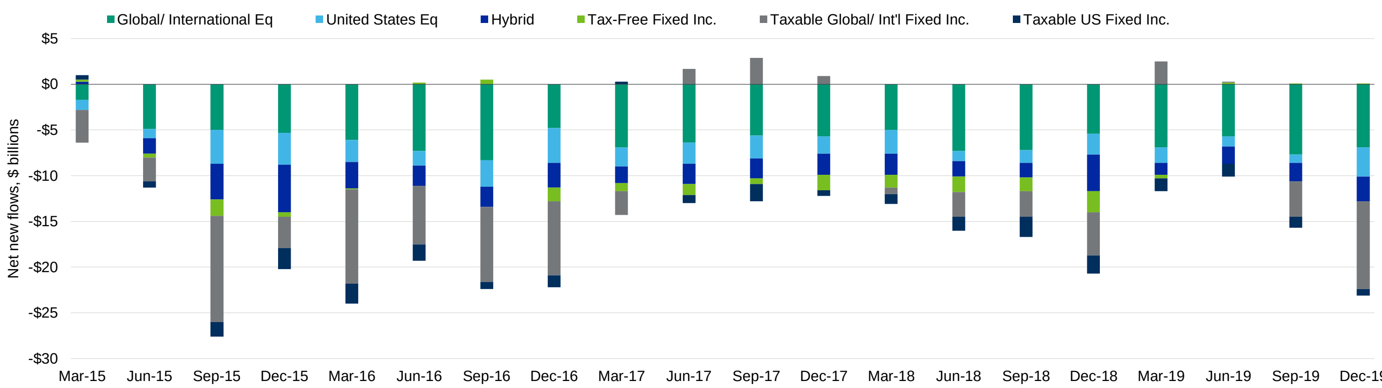
Franklin Resources' acquisition of Legg Mason, while credit positive, faces challenges

On 18 February, Franklin Resources, Inc. (Franklin, A2 stable) and Legg Mason Inc. (Baa1 review for upgrade) jointly announced the sale of Legg Mason to Franklin. With $1.5 trillion of assets under management (AUM), the combined firm will be one of the largest asset management companies in the world. The acquisition will be credit positive for Franklin, although in our view, the acquirer faces many obstacles.

After the announcement, we affirmed Franklin's rating, noting however that the acquisition leaves in place growth challenges with which the company has struggled in recent years. These include persistently high net redemptions: for the past five years, quarterly long-term redemptions have exceeded long-term sales every quarter, by between $5.4 billion and $27.6 billion, for a cumulative deficit of $322.3 billion (Exhibit 1).

Exhibit 1

Long-term net redemptions have drained $322 billion from Franklin funds over five years

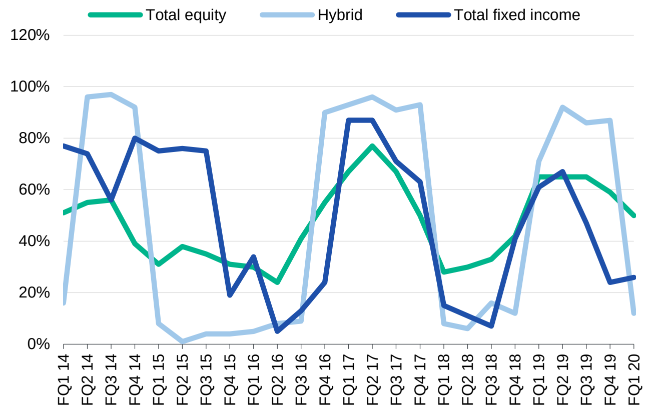


Sources: Franklin Resources company reports and Moody's Investors Service

Leading franchise funds, such as Franklin Income and Templeton Global Bond, which historically employed idiosyncratic investment programs to produce competitive returns, have in recent years operated in market environments that were challenging for macro-style investors. Across the franchise, the "first to worst" pattern of relative performance over shorter, one- to three-year time frames appears to have worn down investors, as superior five- to ten- year performance records eroded versus peers. (Exhibits 2-4)

Exhibit 2

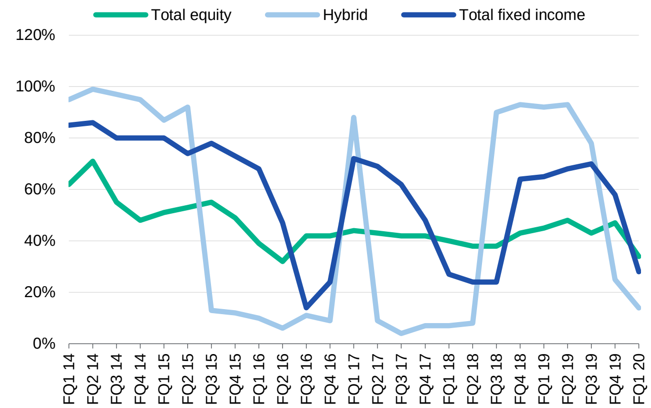
One-year performance by asset class: percent of AUM in top two peer group quartiles



Source: Franklin Resources company reports and Moody's Investors Service

Exhibit 3

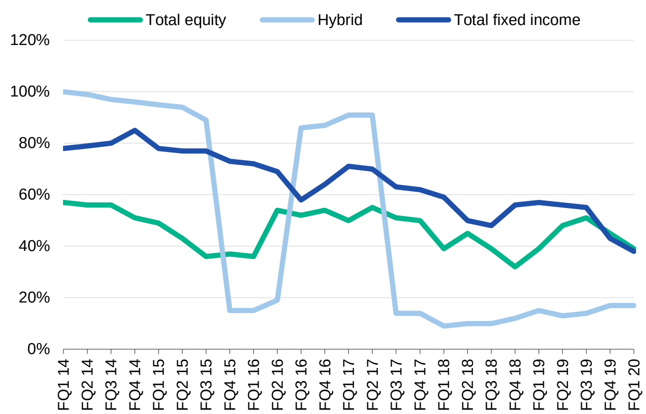
Three-year performance by asset class: percent of AUM in top two peer group quartiles



Sources: Franklin Resources company reports and Moody's Investors Service

Exhibit 4

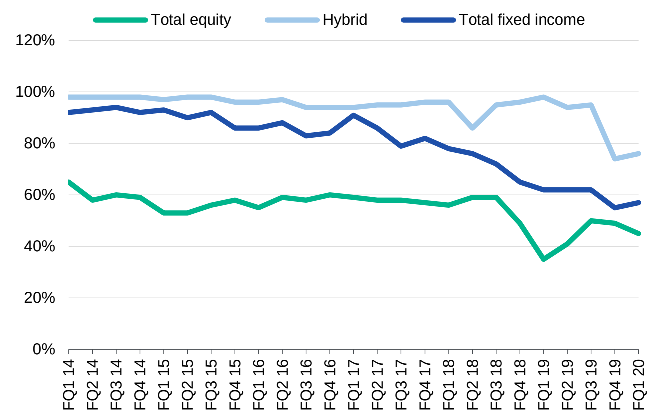
Five-year performance by asset class: percent of AUM in top two peer group quartiles



Source: Franklin Resources company reports and Moody's Investors Service

Exhibit 5

Ten-year performance by asset class: percent of AUM in top two peer group quartiles



Sources: Franklin Resources company reports and Moody's Investors Service

In addressing the rationale for the acquisition, management noted specific benefits. Franklin will be acquiring eight of Legg Mason's independent affiliates (Exhibit 6), with nearly $800 billion of assets under management. These will bring both new products, which will be additive to Franklin's current offerings, as well as complementary services, mainly in distribution, which should fortify Franklin's traditional strengths in wholesaling mutual funds.

Exhibit 6

Legg Mason affiliates to be acquired by Franklin Resources

Rank by contribution to Legg Mason pretax earnings	Legg Mason affiliate	AUM ($ billions)
1	Western Asset	456.3
2	ClearBridge Investments	154.2
3	Clarion Partners	54.8
4	Brandywine Global	74.0
5	Royce Investment Partners	13.7
6	Rare Infrastructure	4.9
7	Martin Currie	17.2
8	QS Investors	12.4
Total		**787.5**

Source: Legg Mason company reports

Among the products of greatest interest to Franklin are Western Asset Management's strong stable of global core and specialized fixed-income funds, and Clarion Partners' institutional real estate funds. A significant share of both businesses' clients are institutional, which will raise Franklin's institutional business to 51% from 25% of total AUM. Clarion's $54 billion of AUM will more than double Franklin's alternative offerings.

Franklin will hope to leverage Legg Mason's success building a global separate managed account business. Legg Mason recently reported that its distribution business had over $90 billion in US retail separate accounts, and $36 million in international separate accounts, which will raise Franklin's position to the third largest in this channel. Separate accounts, which have attractive fee and tax attributes, have grown rapidly as a vehicle used by wealth advisors.

There is unquestionably a significant degree of integration risk in such a large acquisition, given the number of separate investment organizations and the multiplicity of interfaces between product and distribution teams. While Franklin's distribution efforts have struggled, Legg Mason's global distribution results were relatively strong, having experienced just three negatively flowing quarters in the last 6 years. These results were supported with competitive performance: 76% of fund assets outperformed peer group averages for the past five years.

A key to mitigating integration risk will be aligning the investment organizations with new distribution structures. Inevitable redundancy will require a careful selection of the teams that are most able to capitalize on the combined firms' legacy capabilities as they integrate their efforts. Only time will tell if fund performance, distribution intelligence, budgeting, technology, and individual incentives will come together to fully recognize the potential of a $1.5 trillion asset manager.

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Opposition to natural gas pipeline highlights Canada's exposure to social and environmental risks

Originally published on 21 February 2020

On 20 February, Canada's (Aaa stable) Prime Minister Justin Trudeau held an urgent call with the country's Council of the Federation, a congress comprised of all of the premiers of Canada's provinces and territories, to discuss how to resolve various transportation blockades and protests occurring across the country that are negatively affecting the economy. The blockades started over two weeks ago in the Tyendinaga Mohawk Territory of Ontario, where demonstrators blocked a railway to express support for the hereditary chiefs of the indigenous Wet'suwet'en of British Colombia. The chiefs oppose the construction of the country's Coastal GasLink (CGL) natural gas pipeline project, which aims to significantly increase Canada's exports of liquified natural gas (LNG).

The protests have since spread across the nation, negatively affecting economic activity by blocking the transport of goods and commuters and highlighting how environmental, social and governance (ESG) risks can impact the Canadian sovereign. If the blockades were to persist, they would increasingly weigh on economic activity, creating downside risks to our 1.5% real GDP growth forecast for 2020. However, we expect the protests to be transitory, followed by a quick rebound in commercial activity once a resolution is reached, resulting in more limited economic impact over the course of the year.

Since the blockades began, key national supply routes have been shut down, leaving products stranded on rails and in ports across the country. This has most affected Canadian rail companies. For example, Via Rail (NR), the largest passenger-rail operator in Canada, temporaily laid off around 1,000 employees and Canadian National Railway Company (CN, A2 stable) temporarily laid off around 450 employees. Ports across the country also have heavier-than-usual anchorage volumes because outbound ships cannot depart without their cargos and inbound ships cannot unload cargoes because of the blocked railways. Industry groups that use the railways for transporting their goods have also voiced concerns that the barriers erected on the rails could eventually result in shortages for small businesses and impose undue harm on Canada's commercial reputation as a reliable trade partner.

The CGL natural gas pipeline project aims to increase exports of cleaner burning LNG from western Canada to Asian markets, which largely rely on fuel sources that have higher carbon emissions. About $5 billion is being invested into the 416-mile project, which started construction in 2019 to enter into service in 2023. The pipeline would start supplying the LNG Canada plant, which is concurrently under construction, so that the plant could start delivering LNG before 2025. The construction phase of the project will increase employment by creating thousands of new jobs and supporting demand for ancillary services. Overall, Canada's oil and gas sector contributed around 6% to the country's real GDP in 2018. It is a particularly important source of jobs and government revenue for oil-exporting provinces such as Alberta (Aa2 stable) and Saskatchewan (Aaa stable).

The Canadian government has increased its involvement in the conflict between CGL and the hereditary chiefs in an effort to promote active dialogue toward reaching resolution. Although CGL has agreements with all 20 elected indigenous bands along the route, the Wet'suwet'en hereditary chiefs oppose the project because it crosses their traditional lands.

Disputes over indigenous land rights and granting right-of-way for infrastructure projects are not new for the Canadian government. In recent years, all high profile oil pipeline projects have had resistance from various stakeholders over both environmental and social concerns and either faced significant delays or cancellation. For example, the Canadian government took ownership of the Trans Mountain oil pipeline, which carries crude and refined oil from Alberta to the coast of British Columbia (Aaa stable), after the previous private-sector owner was set to abandon its expansion project over legal and political challenges because of the project's potential negative environmental impact. Meanwhile, social risks and opportunities from such projects stem from interactions with core stakeholders including employees, customers, supply chain partners, counterparties or society at large.

Although Canada is exposed to ESG-related risks, relative to many other advanced economies, it has demonstrated a clear focus on addressing environmental and social concerns, including through the mitigation of climate change and resolution of indigenous land rights issues. These efforts, combined with its very strong institutions and governance framework, help limit potential ESG risks to the sovereign's credit profile.

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Singapore's budget stimulus addresses shocks and structural challenges, while maintaining fiscal discipline

Originally published on 19 February 2020

On 18 February, Singapore's (Aaa stable) Deputy Prime Minister and Minister for Finance Heng Swee Keat unveiled the government's budget for fiscal 2020 (starting April 2020), along with revised estimates for fiscal 2019. Amid greater uncertainty in the global economy, in part because of the coronavirus outbreak, the government has called for record high expenditure to support economic growth, and its widest-ever deficit. The large near-term budgetary expansion does not threaten Singapore's fiscal strength, and the government has sustained its focus on addressing long-term social and environmental pressures, a credit positive.

The fiscal 2020 budget calls for a 13.0% rise in total outlays,[1] against a smaller 3.1% increase in combined receipts from operating revenue and returns from its large fiscal reserves.[2] Total outlays are projected at 20.3% of GDP, a record high, up from 18.4% in fiscal 2019.

The large fiscal expansion aims to offset the near-term economic fallout from the outbreak of the coronavirus, in an already challenging global environment. The government has lowered its estimate for real GDP growth in 2020 to minus 0.5%-1.5% from 0.5%-2.5%.

Temporary stimulus measures include a SGD4 billion (0.8% of GDP) package to help companies with their cash flow and to retain employees, a SGD1.6 billion (0.3% of GDP) package to augment household income, and an additional SGD800 million (0.2% of GDP) to support front-line agencies involved in containing the viral outbreak.

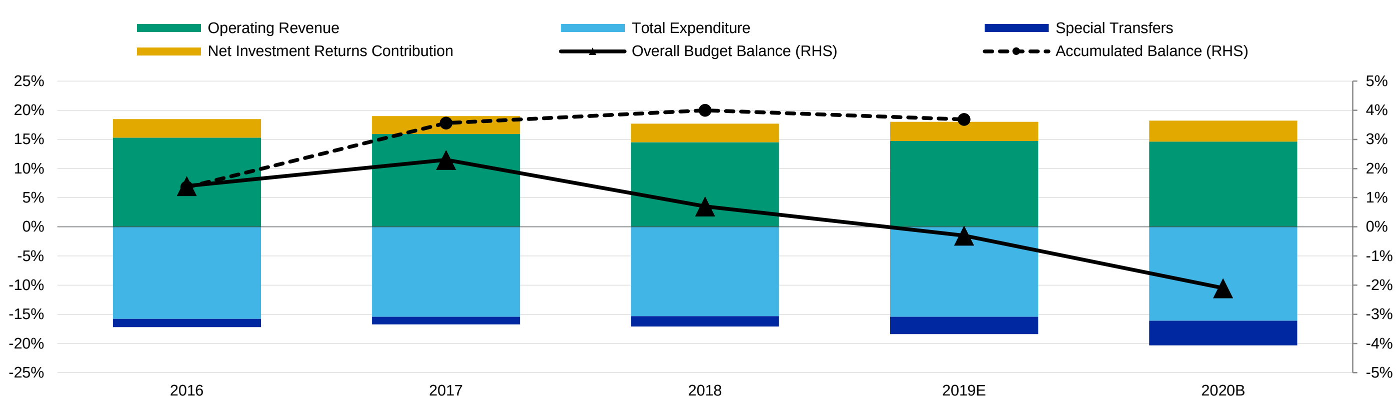
Overall, the budget projects a deficit of SGD10.9 billion (2.1% of GDP), wider in nominal Singapore dollar terms than the SGD8.7 billion (3.5% of initially estimated GDP) deficit that the government budgeted for fiscal 2009 to counter the impact of the global financial crisis.

The record deficit does not threaten Singapore's strong fiscal position. The country's prevailing fiscal rules require the government to maintain a balanced budget over the course of its five-year term in office and prohibits the issuance of debt to finance deficits.

The current government, which was elected in 2015, has entered into its last full year in office with an accumulated surplus of SGD18.7 billion (3.7% of GDP) (see Exhibit 1). This amount is sufficient to fund the projected shortfall for fiscal 2020, while leaving approximately SGD7.7 billion (1.5% of GDP) to ramp up spending further if needed.

Exhibit 1

Surpluses accumulated over the past four years are sufficient to fund the large deficit
(Percent of GDP, fiscal years)



Sources: Ministry of Finance and Moody's Investors Service

For fiscal 2019, the government has estimated an overall budget deficit of SGD1.7 billion (0.3% of GDP), narrower than the SGD3.5 billion (0.6% of initially forecast GDP) deficit projected in the 2019 budget, despite a deterioration in economic growth. The latter contributed to weaker consumption tax and motor vehicle-related receipts than the government projected. But these were more than offset by a combination of higher transfers from statutory boards including the central bank, robust personal income tax receipts, and underspending on defense and transport.

The budget retains the focus of previous years on addressing the rising cost of living, increasing the productivity and scale of local companies, and ensuring the employability of Singaporeans.

The long-term pressures of an ageing society remain a focal point, with announced enhancements to the social safety net for elderly citizens. Healthcare expenditure, which has tripled over the past decade, will increase by an additional 16.2% and is the largest driver of expenditure growth (excluding special transfers) incorporating measures related to containing the coronavirus outbreak, as well as higher subsidies to public hospitals and hospital development projects. To spur productivity, the government has ramped up support for training and skills upgrading, while also announcing further restrictions on foreign labor.

The budget also highlights the government's commitment to managing climate change. The finance minister announced a forthcoming update to Singapore's commitments under the Paris Agreement. The budget provides for SGD5 billion (1.0% of GDP) to establish a fund to address the risk of rising sea levels.

Additionally, the government announced a goal to phase out all vehicles with internal combustion engines by 2040, introducing a mix of rebates, early adoption incentives and changes to motor vehicle taxes to spur adoption of more environmentally friendly vehicles.

Endnotes

1 Including operating and development expenditures, special transfers and top-ups to endowment and trust funds.

2 Under the Net Investment Returns Contribution framework, up to half of the long-term expected returns earned on the government's net assets managed by its sovereign wealth funds, Temasek Holdings (Private) Limited (Aaa stable) and GIC Pte Ltd, along with the Monetary Authority of Singapore, are available for spending on the government budget.

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General Motors' withdrawal from Australia is credit negative for Australian auto ABS

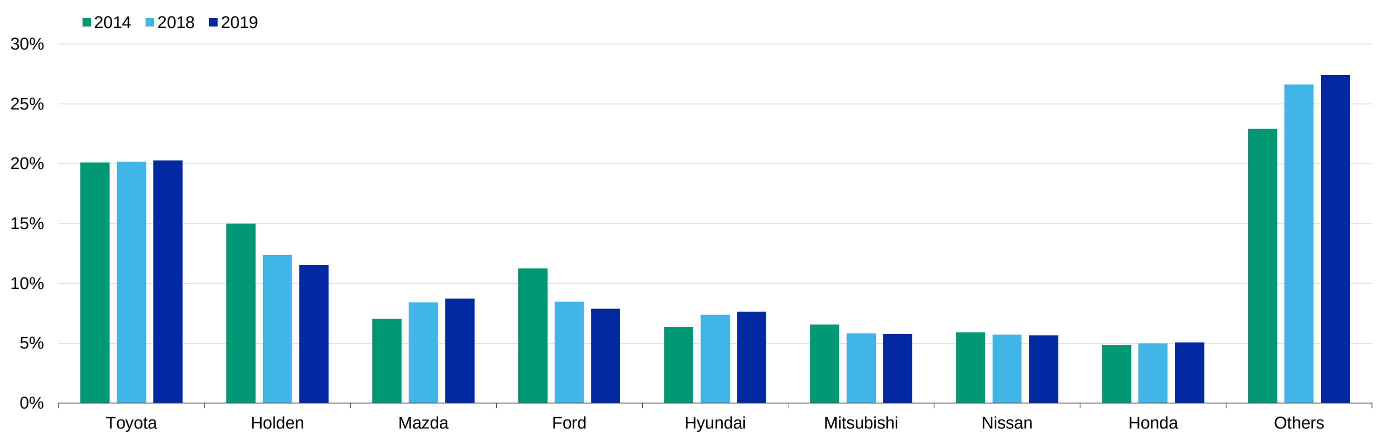
On 17 February, General Motors Company (GM, Baa3 stable) announced that it would withdraw from the Australian and New Zealand vehicle market by June 2020. GM's exit will be credit negative for Australian auto asset-backed securitisations (ABS) because it will reduce the resale value of GM vehicles.

The removal of long-term support for GM's Holden brand and the maintenance of vehicles will reduce these vehicles' resale values in the coming years, which will affect loans and leases originated with residual value. Residual value loans are exposed to market valuations because of the possibility of borrowers returning cars at the end of the loan term instead of paying a balloon payment.

The residual value price is calculated at the start of the loan or lease and not revised throughout the term, so a reduction in the resale value of the motor vehicle risks causing a loss on the outstanding balance owing to the residual value calculated being higher than the realised resale value. Borrowers with residual value loans or leases are more likely to return the car at the end of the loan term rather than pay for it given that the car will have a lower valuation in the secondary market than the remaining payment. For non-residual value loans or leases, the risk of secondary resale values will only occur if the borrower defaults on the loan.

However, the effect on ABS will be limited because the demand for Holden vehicles has been declining (see exhibit). GM, through Holden, had historically maintained significant local consumer support over Holden's 164-year history, but this support has been contracting since 2004, when Toyota became the top-selling manufacturer in the Australian market. This was exacerbated by the relocation of manufacturing offshore in 2017. The pace of the sales decline has picked up in recent years, with Holden selling only 43,176 vehicles in 2019, versus Toyota's 205,766, according to carsales.com Limited. GM will provide 10 years of support on parts and servicing while also maintaining employees in Australia, which will reduce the decline in the resale values over the next three to five years.

Percentage of total stock of cars in the Australian market



Source: Australian Bureau of Statistics

Affected ABS deals we rate have varying exposure to Holden. The highest exposures are 23.5% and 16% in two seasoned deals with no exposure to residual value. The remainder of the exposures are approximately 10% or below, with some of these deals containing residual value and balloon payments.

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CREDIT IN DEPTH

Higher fourth-quarter revenue and good cost control support European global investment banks' operating leverage and profit

Originally published on 19 February 2020

In this report we provide key take-aways from the quarterly financial results of the seven European Global Investment Banks (GIBs): Barclays Bank PLC (A1/A1 stable, baa3[1]), BNP Paribas (BNPP, Aa3/Aa3 stable, baa1), Credit Suisse AG (A1/A1 positive, baa2), Deutsche Bank AG (DB, A3/A3 negative, ba1), HSBC Bank plc (Aa3/Aa3 negative, baa2), Société Générale (SG, A1/A1 stable, baa2) and UBS AG (Aa2/Aa3 stable, a3).

The seven European GIBs reported an aggregate adjusted pretax profit of $13.0 billion in the fourth quarter, a credit positive increase of 46% from $8.9 billion in the same period a year earlier. The improvement reflects benign operating conditions in capital markets during the quarter, largely offsetting persistent strain from the low-interest-rate environment. Despite improved results, the European GIBs continue to lag the absolute earnings power of the five US-based GIBs (Bank of America Corporation, Citigroup Inc., The Goldman Sachs Group, JPMorgan Chase & Co. and Morgan Stanley), which reported an aggregate pretax profit of $29.5 billion in fourth-quarter 2019, up 5% year over year.

» **Operating leverage returns as capital markets businesses recover, supporting pretax profit.** Capital markets revenue (21% of total) grew 23% (adjusted for DB's equity revenue, which was transferred to the Capital Release Unit in third-quarter 2019) as higher client activity and improved market-making conditions in fixed-income sales and trading supported revenue. However, primary market revenue did not keep pace with the strong rebound at US peers. Non-capital-markets revenue (79% of total) increased 3%, with loan growth and expense control offsetting continued strain on margins. Margin pressure also affected some of the European GIBs' US franchises, following US rate cuts later in the year. Operating costs for the European GIBs increased 2%, excluding the effects of conduct and litigation charges and other exceptional restructuring costs[2], leading to an average cost to income ratio of 81%, down from 83% in the same quarter a year earlier.

» **Loan loss charges begin to normalise.** Asset quality at the European GIBs remained strong during the quarter. However, aggregate loan loss charges rose 8% sequentially to $3.3 billion, reflecting continued global macroeconomic uncertainty and trade tensions, as well as strong comparables in the previous quarter coupled with lower write-backs.

» **Capital and liquidity remain strong.** The median Common Equity Tier 1 (CET1) ratio of the seven European GIBs improved 50 basis points year over year to 13.6%, mirroring improved operating leverage and continued risk-weighted assets reductions at some banks. The peer group's average liquidity coverage ratio of 147% in fourth-quarter 2019 continues to indicate strong mitigation of wholesale funding and refinancing risks by sufficient volumes of high-quality liquid assets, a credit strength.

Click here for the full report.

Endnotes

1 The ratings shown are the long-term senior unsecured debt and the long-term deposit rating (where available) and the Baseline Credit Assessment.

2 For example those at DB, whose cost base was meaningfully impacted by onetime charges as a result of its more radical restructuring program. Excludes HSBC's $7.3 billion goodwill write-down.

JPMorgan Chase's efficiency-driven operating leverage helps hone credit-positive competitive edge

Originally published on 20 February 2020

Summary

The efficiency of JPMorgan Chase & Co. (JPM, A2 stable, a2[1]), has long been a competitive advantage over most peers. Moreover, the bank achieved its 55% long-term cost-income ratio target in 2019[2] despite three interest rate cuts in the second half of the year. The rate cuts contributed to a 37-basis-point decline in its core net interest margin (excluding CIB markets)[3] to 3.06% at year end from 3.43% in the first quarter. If JPM recommits to a 55% cost-income goal through the cycle at its 28 February investor day, it would be a continued credit positive for its bondholders.

» **JPM's scale-driven efficiency distinguishes it from many peers.** The strength and stability of JPM's profitability through the cycle is a key credit positive for the bank's bondholders and underpins our two-notch positive adjustment in JPM's scorecard for diversification, the only such adjustment for a Moody's-rated bank.

» **Balanced organic growth and disciplined control of non-technology operating expenses counteract pressure on net interest margin (NIM).** Economies of scale drive high operating leverage across JPM's four franchises, especially within the Consumer & Community Bank (CCB). This creates a virtuous cycle in which rising balances of loans, deposits and client assets, together with increased client activity, drive growing revenue streams that can be directed to accelerate technology spending, attract new customers and lower costs to serve, preserving the high operating leverage that underpins the process.

» **JPM is harnessing the virtuous cycle of high operating leverage to entrench its competitive advantage.** In 2019, the bank's technology, communications and equipment expenses were $9.8 billion, equal to 18% of its pre-provision profit and roughly double the disclosed technology expenses of the five largest US regional banks[4]. JPM's ability and willingness to invest its vast resources into new technology solutions and services provides it a formidable arsenal to maintain its lead versus peers, to deter new competitors, or to attract financial technology allies in an increasingly digital banking marketplace.

Click here for the full report.

Endnotes

1 The ratings shown are JPMorgan's holding company senior debt rating and Baseline Credit Assessment.

2 The 55% ratio is quoted on a fully-taxable equivalent (FTE) basis. FTE adjusts reported GAAP financials to place investments that receive tax credits and tax-exempt investments on a comparable basis to fully taxable investments, with an offsetting increase to income expense and has no effect on overall net income.

3 To facilitate comparison with regional bank peers, JPM discloses both a corporate-level NIM and a NIM that excludes the impact of the Corporate and Investment Banking segment

4 Truist, US Bancorp, PNC, Fifth Third and KeyCorp. This comparison is based on disclosed income statement technology line items. Some banks occasionally disclose broader technology investment spending, but this is not disclosed consistently and the breakdown between "run the bank" and "change the bank" spending and capitalization vs. expensing is unclear

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CREDIT IN DEPTH

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